

2012

HI-Country Estates Homeowners Association Phase II v. Keith Emmer, Tom Williams, Anthony Sarra, Arlene Johnson, and Carol Dean: Brief of Appellant

Utah Supreme Court

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Glenn C. Hanni; Stuart H. Schultz; Strong and Hanni; Attorneys for Defendants/Appellees.
Troy L. Booher; Clemens A. Landau; Zimmerman Jones Booher LLC; Wad R. Budge; Michael J. Thomas; Snell and Wilmer LLP; Attorneys for Plaintiff/Appellants.

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IN THE UTAH SUPREME COURT

**HI-COUNTRY PROPERTY RIGHTS
GROUP, LINDSAY ATWOOD,
JERRY GILMORE, and BRANDON
FRANK, individually and for and on
behalf of HI-COUNTRY ESTATES
HOMEOWNERS ASSOCIATION,
PHASE II,**

Plaintiffs/Appellants,

v.

**KEITH EMMER, TOM WILLIAMS,
ANTHONY SARRA, ARLENE
JOHNSON, CAROL DEAN, HI-
COUNTRY ESTATES
HOMEOWNERS ASSOCIATION,
PHASE II, and DOES 1-100,**

Defendants/Appellees.

No. 20120202-SC

**On appeal from the Third Judicial
District Court, Salt Lake County,
Honorable Tyrone E. Medley,
District Court No. 090920250**

OPENING BRIEF OF APPELLANTS

**Glenn C. Hanni
Stuart H. Schultz
STRONG & HANNI
3 Triad Center, Suite 500
Salt Lake City, UT 84180**

Attorneys for Defendants/Appellees

**Troy L. Booher (9419)
Clemens A. Landau (12178)
ZIMMERMAN JONES BOOHER LLC
Kearns Building, Suite 721
136 South Main Street
Salt Lake City, UT 84101
tbooher@zjbappeals.com
(801) 924-0200**

**Wade R. Budge (8482)
Michael J. Thomas (12688)
SNELL & WILMER LLP
15 West South Temple, Suite 1200
Salt Lake City, UT 84101
wbudge@swlaw.com
(801) 257-1900**

Attorneys for Plaintiffs/Appellants

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Troy L. Booher (9419)
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ZIMMERMAN JONES BOOHER LLC
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Michael J. Thomas (12688)
SNELL & WILMER LLP
15 West South Temple, Suite 1200
Salt Lake City, UT 84101
wbudge@swlaw.com
(801) 257-1900

Attorneys for Plaintiffs/Appellants

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Jurisdictional Statement

This is an appeal from an order dismissing derivative claims brought by Plaintiffs on behalf of Hi-Country Estates Homeowners Association, Phase II (“HOA”) against its directors – Keith Emmer, Tom Williams, Anthony Sarra, Arlene Johnson and Carol Dean (“Directors”). This court has jurisdiction under Utah Code sections 78A-3-102(3) and 16-6a-612(4)(g), which permits an appeal of right from orders dismissing derivative claims under Utah Code section 16-6a-612(4)(a). Because only the derivative claims are at issue in this appeal, the appellant is the HOA and the appellees are the Directors.

Statement of the Issues

Under Utah law, members of a nonprofit corporation may bring derivative claims in the name of the corporation against its directors when those directors harm the corporation or otherwise do not act in its best interest. Utah Code §16-6a-612. Utah law also provides a mechanism to dismiss derivative claims, not on their merits, but on the ground that their maintenance is not in the corporation’s best interest. To ensure dismissal is in the corporation’s best interest – rather than a self-serving decision of its directors – the best-interest determination must be made by a person or group capable of exercising independent business judgment: (i) a quorum of independent directors; (ii) a person or group appointed by the court acting in place of the directors; or (iii) an independent special litigation committee consisting of members appointed by independent directors and acting in place of the directors. Utah Code §16-6a-612(4)(b), (4)(f).

Here, the Directors did not ask the court to appoint anyone to evaluate the derivative claims. And because there was not a quorum of independent Directors, the Directors created a special litigation committee. Under section 16-6a-612(4)(a), a special litigation committee must be independent and conduct a reasonable inquiry to determine whether maintenance of the derivative claims is in the best interest of the corporation. And under section 16-6a-612(e)(1), if a majority of Directors are not independent, then the directors have the burden of proving the special litigation committee complied with subsection (4)(a).

In this case, the Directors who committed and profited from the alleged wrongdoing appointed a special litigation committee populated by other defendants who committed and profited from the alleged wrongdoing. The committee made observations and recommendations, but did not consider whether maintenance of the derivative claims was in the best interest of the HOA and did not recommend dismissal of the claims. Instead, the Directors themselves voted to direct counsel to move to dismiss the derivative claims.

Issue 1: Whether directors have the burden to prove compliance with Utah Code section 16-6a-612(4)'s standards that govern the appointment and conduct of special litigation committees where (i) the plaintiff presents evidence in a verified complaint that a majority of the directors were not independent because they engaged in and profited from the alleged wrongdoing and (ii) section 16-6a-612(4)(e) places the burden of proof on the directors where a majority of directors are not independent.

Standard of Review: Because the district court refused to rule on this issue, this court interprets the statute in the first instance. (R.1562-63,1761-64.)

Issue 2: Whether a special litigation committee is independent under section 16-6a-612(4)(b) where its members engaged in and profited from the alleged wrongdoing and were appointed by directors who engaged in and profited from the alleged wrongdoing.

Issue 3: Whether a special litigation committee conducts a reasonable inquiry under section 16-6a-612(4)(a), where the committee provides only a legal analysis of the derivative claims but does not make the ultimate decision concerning whether dismissal of the derivative claims would be in the best interest of the corporation.

Standard of Review: The standard of review constitutes a separate issue in this appeal, but is an issue on which both parties and the district court agree. This court has not articulated a standard of review for orders dismissing derivative claims under section 16-6a-612(4), but courts in other jurisdictions review such orders under the summary judgment standard that requires viewing the facts and all reasonable inferences in the light most favorable to appellants. Zapata Corp. v. Maldonado, 430 A.2d 779, 788 (Del. 1981); Janssen v. Best & Flanagan, 662 N.W.2d 876, 889 (Minn. 2003); Finley v. Superior Court, 80 Cal. App. 4th 1152, 1160-61 (2000). This court should apply the same standard, especially since the Directors urged the district court to apply – and the court did apply – Rule 56 standards in adjudicating the motion. (R.1382,1388,1405.)

Preservation: All three issues were preserved in the memoranda in opposition to the motions to dismiss, (R.1547,1556,1561-66), and again at oral argument on the motion to dismiss. (R.1892:21-22,33,46.)

Determinative Provisions

The following provisions are set forth at Addendum B:

Utah Code §16-6a-612

Utah Code §16-6a-822

Utah Code §16-10a- 740

Model Business Corporations Act §§1.43, 7.44

Model Nonprofit Corporations Act §§1.40, 13.03, 13.05

Principles of Corporate Governance §§1.23, 7.09

The following cases are at Addendum C:

Einhorn v. Culea, 612 N.W.2d 78 (Wis. 2000)

Janssen v. Best & Flanagan, 662 N.W.2d 876 (Minn. 2003)

London v. Tyrrell, Civ. No. 3321-CC, 2010 WL 877528 (Del. Ch. Mar. 11, 2010)

Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981)

Statement of the Case

I. Nature of the Case and Course of Proceedings

On November 25, 2009, Plaintiffs filed a verified complaint against the Hi-Country Estates Homeowners Association, Phase II ("HOA"), and the five members of its board of directors: Keith Emmer, Tom Williams, Anthony Sarra, Arlene Johnson, and Carol Dean ("Directors"). (R.1-16.) Those claims remain pending in the district court and are not at issue in this appeal. Plaintiffs also filed a derivative claim on behalf of the HOA against the Directors for breach of fiduciary duty. (*Id.*) Only the derivative claim is at issue in this appeal.

Instead of addressing the merits of the derivative claims, the Directors appointed a special litigation committee to evaluate the claims and then moved to dismiss under Utah Code section 16-6a-612.¹ (R.316A-316C.) Once the Directors filed that motion, the court stayed the merits to allow the parties to conduct discovery on whether the special litigation committee was independent, conducted a reasonable inquiry, and acted in good faith. (R.1039-40.) After limited discovery, the Directors renewed their motion to dismiss. (R.1381-83.)

¹ "A derivative proceeding shall be dismissed by the court on motion by the corporation if a person or group specified in Subsection (4)(b) or (4)(f) determines in good faith, after conducting a reasonable inquiry upon which the person's or group's conclusions are based, that the maintenance of the derivative proceeding is not in the best interest of the nonprofit corporation.

...

[T]he determination in Subsection (4)(a) shall be made by . . . a majority vote of a committee consisting of two or more independent directors appointed by a majority vote of independent directors present at a meeting of the board of directors" Utah Code §16-6a-612(4)(a)-(b).

On February 23, 2012, the court granted the motion, ruling that the Directors had demonstrated that there was no genuine issue of material fact concerning the special litigation committee's independence, its good faith, the reasonableness of its inquiry, or whether it had determined that maintenance of the derivative claims is not in the best interest of the HOA. (R.1761-64;Add. A.)

The HOA appealed under section 16-6a-612(4)(g), which provides an appeal of right from orders dismissing derivative claims under section 16-6a-612.

II. Statement of Facts

A. Hi-Country Estates Phase II, HOA, & Board

The Hi-Country Estates Phase II ("HCEII") development has been located in the southwest corner of Salt Lake County near Herriman since the mid-1970s. (R.3,482.) The HOA has a five-person board of directors. (R.1519-20.) The Directors also hold management positions, including President, Vice President, Director of Legal, Director of the Architectural Control Committee, Director of Roads, Director of Water, and Director of Community Affairs. (R.440,442,455.)

The HOA board has three main functions: road maintenance, maintain the common area, and administer the water system. (R.464-65.) Those functions are funded from annual assessments and income from its water system. (R.464.) Because the water system pays for itself and the common area is a bus shelter and mailbox structure, the annual assessments are primarily for road maintenance – e.g., more than 97% of the proposed non-water-system maintenance budget in 2009-2010 was devoted to roads. (R.464;1493.)

Although HOA has a Director of Roads, every member of the board participates in road maintenance. (R.344.) Board members annually “drive the HOA area and identify deteriorated areas on roads that lead to residences” and “respond to complaints regarding the condition of roads.” (Id.)

B. The Derivative Claims Are Based Upon Discriminatory Board Decisions Over the Past Twenty Years

Plaintiffs are lot owners in “Area D” of HCEII and members of the HOA. (R.1051-52.) For twenty years, Plaintiffs, as well as other lot owners in Area D, have been unable to develop their lots – which are many acres in size – due to the Directors’ discriminatory allocation of road maintenance resources that has resulted in Area D roads that are accessible only by foot, horseback, or ATV. (R.49-51,1056-57,1444,441 (one Plaintiff hampered by road issues since 1992); R.410 (Area D lot owners threatened suit in 1993 based upon neglect of roads).)

Due to the discriminatory allocation of road maintenance resources, on June 12, 2009, Plaintiffs sent a notice of claim and written demand to the Directors under Utah Code section 16-6a-612(3)(a). (R.53-57.) On September 10, 2009, the Directors elected a special litigation committee to investigate the claims. (R.59-60.) After expiration of the 90-day waiting period set forth in Utah Code section 16-6a-612(3)(a), Plaintiffs filed their claims on November 25, 2009. (R.14.)

C. All Directors Participated in and Profited from the Alleged Wrongful Conduct

At the time the special litigation committee was selected, there were five members on the HOA board: Keith Emmer, Arlene Johnson, Tom Williams,

Anthony Sarra, and Carol Dean. (R.1520.) Over the past twenty years, each Director played a significant role in the discrimination against lot owners in Area D. (R.1519-20.) A review of the committee report reveals that issues concerning the poor condition of the Area D roads arose at least yearly, and sometimes monthly, during the time Mr. Emmer, Ms. Johnson, Mr. Williams, Mr. Sarra, and Ms. Dean served in their decision-making roles. (R.348,350-51.)

A brief summary of each Director's involvement in road decisions is relevant to the independence of (i) Directors who appointed the members of the special litigation committee, (ii) members of the committee, and (iii) the Directors who decided that dismissal was in the best interest of the HOA. (R.1477.)

Keith Emmer. Mr. Emmer is a Director who appointed the members of the special litigation committee and is a defendant to the derivative claim who engaged in "self-dealing and favoring services to and improvements benefitting" his own property. (R.1561.)

Mr. Emmer has served on the board of directors for more than 15 years. (R.1519-20.) He has held a number of important board positions, ranging from Director of the Architectural Control Committee to President of the Board. (R.435,440,442,444,445,455,459,461,500.) As a result, he has been an integral player in the lengthy dispute with the Plaintiffs over road maintenance. (R.420-25 (correspondence between Emmer and the HOA's attorney in 1995 regarding roads in Area D); R.569-70 (email from Emmer justifying the neglect of Area D roads); R.579 (email from Emmer analyzing claims).)

As President, Mr. Emmer often took a lead role in investigating and addressing disputes regarding the condition of roads. (R.450 (presented on road damage at 2007 annual meeting); R.456 (discussed committee to create long-term road plan at the 2008 annual meeting).) Emmer had frequent contact with Howard Lundgren, the HOA's attorney, on matters relevant to the derivative claims. (R.633-37 (letter from Lundgren to Emmer regarding claims); R.677-79 (email between Emmer and Lundgren regarding same).) Despite Mr. Emmer's involvement in the alleged wrongful conduct, it was Mr. Emmer who first contacted Kim Wilson (discussed below) about serving as the chairperson of the special litigation committee. (R.1482.)

Arlene Johnson. Ms. Johnson is a Director, member of the special litigation committee, and a defendant who engaged in "self-dealing and favoring services to and improvements benefitting" her own property. (R.1561.)

Ms. Johnson made road maintenance decisions for the HOA for more than a decade. (R.1496.) Ms. Johnson served on the board from 1991 to 1995 and since 2001. (R.1519-20.) Notably, Ms. Johnson served as Director of Roads during a substantial period of her time on the board. (R.435,440-48,455,459,461,500.)

As Director of Roads, she presented on the status of roads and prioritized road improvements. (R.438 (presented "wish list for improvements" and four-year plan for road paving at 2005 annual meeting); R.446 (reported on road issues at September 2006 monthly meeting); R.451 (same at 2007 annual meeting); R.455 (explained road proposals at 2008 annual meeting); R.461 (arranged for

road improvements at October 2008 monthly meeting); R.501 (tasked with road improvements at November 2008 monthly meeting).)

Anthony Sarra. Mr. Sarra is a Director and member of the special litigation committee, as well as a defendant who engaged in “self-dealing and favoring services to and improvements benefitting” his own property. (R.1561.)

Mr. Sarra has served on the board since 2002. (R.435-36,1520.) He served as Vice President and Director of Legal. (R.435,440-45,455,459,461,500.) As Director of Legal, Mr. Sarra investigated and opined on legal issues related to roads at nearly every meeting and interacted with the HOA’s counsel – Mr. Lundgren – to obtain guidance. (R.437 (presented plan based upon Lundgren recommendation to “avoid future problems” at 2005 annual meeting); R.446 (provided update on legal issues at September 2006 monthly meeting); R.451 (update on legal issues concerning roads at 2007 annual meeting).)

Mr. Sarra worked closely with Ms. Johnson and Mr. Williams in assessing the condition of the roads, presumably to assess any legal issues related to roads. (R.446 (at September 2006 monthly meeting, Sarra, Johnson, and Williams jointly assessed the status of one of the road projects in HCEII).)

Tom Williams. Mr. Williams is a Director who appointed members of the special litigation committee and a defendant who engaged in “self-dealing and favoring services to and improvements benefitting” his own property. (R.1561.)

Mr. Williams has served on the board of directors since 2003. (R.1520.) Although he was not directly in charge of roads, Mr. Williams was active in road

improvement issues. (R.446 (moving to consider road improvements and use of Sunrise Engineering, Inc. at September 2006 meeting).)

Carol Dean. Ms. Dean was a Director at the time the Notice of Claim was served on the board, having served as a Director from 2007 to 2009. (R.1520.) She served as the Director of Community Affairs. (R.455,459,461,500.) Although Ms. Dean's title appears unrelated to road maintenance, Mr. Emmer stated that all of the Directors were responsible for monitoring the roads within HCEII, responding to road complaints, and identifying deteriorated areas. (R.344.) Ms. Johnson testified that road maintenance decisions were made by consensus after the Directors drove the roads. (R.1491,1496.) Thus, each Director had substantial participation in the wrongful conduct alleged in the derivative claim.

In total, the Directors had collectively served over forty years on the board, and, with the possible exception of one year, at least one of the five served on the board since road disputes began in 1992. (R.1519-20; R.441 (Plaintiff hampered by road issues since 1992); R.410 (Area D lot owners threaten suit in 1993); R.438 (complaints about Area D roads at June 11, 2005 annual meeting); R.441 (impact of poor roads in Area D, including inability to get building permits, discussed at January 2006 monthly meeting); R.449 (Area D roads discussed at 2007 annual meeting); R.460 (discussing document request related to road issues at September 2008 monthly meeting); R.463 (February 27, 2009 letter alerting board of its discrimination and fiduciary duties); R.501 (poor conditions of Area D roads discussed at November 2008 monthly meeting).)

D. The Members of the Special Litigation Committee

All Directors elected two Directors — Arlene Johnson and Anthony Sarra — and one past Director to serve on the special litigation committee and perform the inquiry into the derivative claims. (R.59.) Ms. Johnson and Mr. Sarra's heavy involvement with the HCEII road decisions has been set forth above.

The third member of the special litigation committee was Kim Wilson. (R.59.) Although Mr. Wilson was the only committee member not serving on the board during the years leading up to the filing of the derivative claims, he was similarly tainted by his service on the board from 1994 to 1999 and his business relationship with the HOA. (R.446,1519-20,1579-80.) Between 1994 and 1999, the HOA faced the same legal issues concerning road maintenance. (R.441,410.)

Mr. Wilson owns property within HCEII accessed by Shaggy Mountain Road, one of the roads the derivative claim alleges received preferential maintenance. (R.374.) And Mr. Wilson worked for Sunrise Engineering, Inc., a company the Directors hired to work on HCEII's roads, (R.1579-80), and from which the Directors sought bids for road maintenance projects. (R.446.)

E. The Special Litigation Committee's Investigation

The committee's investigation was based in substantial part on documents from and interviews with the Directors. For example, Mr. Emmer, one of the Directors who selected the committee, was (i) interviewed extensively, (R.2; R.725-38), (ii) asked to present "statement[s] of facts," (R.502-03), and (iii) asked to print out his emails, many of which are relied upon in the committee report.

(R.339-40 nn.30-39,529-667 (section entitled “Keith Emmer’s Emails”).) Given the Directors’ close collaboration on the road issues, it was no surprise that other Directors—including Ms. Johnson, Mr. Sarra, Mr. Williams, and Ms. Dean—were frequently the drafters or recipients of those emails, many of which discuss the derivative claims. (R.530 (Emmer to Johnson, Sarra, Dean); R.544 (Sarra to Emmer); R.547 (Emmer to Sarra, Johnson, Dean); R.548 (Emmer to Sarra, Johnson, Dean, Williams); R.563-64, 568-70 (Sarra, Emmer, Williams, Johnson, and Dean); R.628-37 (Emmer, Sarra, Williams, Johnson, Dean, and Lundgren [HOA’s attorney]); R.640-43 (Emmer, Johnson, Sarra, Williams, and Dean).)

Tom Williams, another Director who selected members of the special litigation committee, responded to written questions regarding the derivative claim, and those responses were used to assess the merits of the claims.

(R.336,362n.224.) Parts of the committee report were based upon a review of “correspondence by Arlene Johnson,” who both elected herself to serve on the committee and drafted the committee report. (R.340n.40,1507-08.)

The committee conducted a number of interviews with Directors, other HOA members, and the Plaintiffs. (R.1392.) The committee did not interview Ms. Johnson or Mr. Sarra—who served on the committee—even though they were Director of Roads and Director of Legal. (R.1393,1486.)

Tellingly, during the interviews, Ms. Johnson, Mr. Sarra, and Mr. Wilson, (likely due to their active participation in the events in question), often testified as to their version of the events, led the witnesses based on their recollection, and

debated with witnesses about the merits of the derivative claims. (R.757 (Hoffman interview in which Wilson testified as to why a road was closed by the County); R.759-63 (Hoffman interview in which both Wilson and Johnson interject facts they learned as Directors and Johnson directs questions to the “combined memory of all [of] us”); R.769-72 (Midlestadt interview in which Johnson testifies about rules applicable to unincorporated areas); R.780 (Messemer interview in which Johnson explains the HOA’s handling of a nuisance near the interviewee’s property); R.792-93 (Plaintiff’s interview in which Johnson and Wilson argue with Plaintiff about the board’s cost estimates for improving roads); R.797-98 (Plaintiff’s interview in which Wilson testifies about road conditions near his lot); R.799 (Plaintiff’s interview in which Johnson testifies how road issues related to certain lots were funded in the 1990s); R.801 (Plaintiff’s interview in which Wilson interprets HOA policies in light of events in the 1990s); R.806-08 (Plaintiff’s interview in which Wilson and Johnson testify about their experience with County zoning regulations).)

F. The Special Litigation Committee Report

The special litigation committee issued its report on May 29, 2010. (R.333-73.) While the report was principally authored by Ms. Johnson, its contents were a result of collaboration among (i) the committee members, (ii) Mr. Lundgren, the HOA’s attorney, and (iii) Mr. Emmer, President of the board. (R.1507-08.)

Importantly, the report contains no conclusion as to whether it was in the HOA’s best interest to maintain the derivative proceeding. (R.1584.) Instead, the

report made fourteen “observations” and three “recommendations,” nearly all of which concern the merits of the claims instead of what is in the best interest of the HOA. (R.333-66.) For example, the report “recommended” that the Directors cooperate with one of the Plaintiffs and share financial records to “clear up any communication problems” and seek legal counsel concerning the fact that some of its records contain confidential personal information. (R.339,358.) And Observation #1 states “The Plaintiffs did not show that there is or has been a de facto residency requirement to be on the board;” Observation #6 states “The Board’s legal counsel’s opinion differs from [appellants’ counsel’s] opinion. Where an issue results in a conflicting interpretation of the law between Attorneys, the Board’s most responsible option is to act according to the opinion of their legal counsel.” (R.340,349.)

Mr. Emmer, after reviewing the report, recommended that the Directors instruct the HOA’s attorneys to move to dismiss the derivative claims under Utah Code section 16-6a-612(4)(a). (R.813.) In his email recommendation, Mr. Emmer listed the Directors by name, indicated that Mr. Sarra and Ms. Johnson would abstain from voting, stated that he would be voting to accept the committee report, and then filled in votes of acceptance for Mr. Williams and Mr. Brown.² (Id.)

² The HOA has been unable to locate any emails from Mr. Williams and Mr. Brown indicating their vote.

Summary of the Argument

The district court erred in dismissing the derivative claims under Utah Code section 16-6a-612(4)(a). Section 16-6a-612(4) provides the directors of a corporation a mechanism to dismiss derivative claims, not on their merits, but on the ground that maintenance of the claims is not in the best interest of the corporation. The mechanism has roots in the business judgment rule, under which courts defer to the business judgment of directors with regard to litigation in the corporation's name. For obvious reasons, courts do not defer to the judgment of directors when the derivative lawsuit alleges that those directors engaged in self-dealing or otherwise harmed the corporation. To do so would allow wrongdoers to control the lawsuit designed to expose their wrongdoing.

Where directors are tainted by their involvement in the wrongdoing, section 16-6a-612(4)(b)(ii) permits the appointment of a special litigation committee to exercise independent business judgment in determining whether maintenance of the lawsuit is in the best interest of the corporation. Specifically, section 16-6a-612(4)(b)(ii) allows the independent directors of a corporation to appoint a special litigation committee that can recommend dismissal after conducting a good faith inquiry into whether maintenance of the derivative claims is in the best interest of the corporation. To warrant deference under the business judgment rule, however, the members of the special litigation committee must be "independent," not unlike arbitrators.

In this case, the derivative claims allege that the Directors of the HOA engaged in self-dealing by maintaining roads (the primary function of the HOA) adjacent to their own properties and neglecting roads adjacent to the Plaintiffs' properties to the point that they became impassable by cars. That neglect has negatively affected Plaintiffs' ability to obtain building permits and the value of their properties. Each Director participated in road-maintenance decisions and benefitted from the discriminatory practices. Yet those same Directors appointed the members of the special litigation committee and two of those Directors served on the committee. In addition, as the third committee member admitted in his deposition, the committee did not consider whether maintenance of the claims is in the best interest of the corporation. And ultimately the Directors, not the committee, made the decision to move to dismiss the derivative claims.

A motion to dismiss under section 16-6a-612 is governed by summary judgment standards, so dismissal was appropriate only if there was no genuine issue of material fact concerning the committee's independence and its inquiry and recommendations. Under that standard, the appointment and constitution of the committee violated the independence requirement in section 16-6a-612(4)(b)(ii) and its inquiry and recommendations violated the good faith inquiry requirement in section 16-6a-612(4)(a).

First, section 16-6a-612(4)(b)(ii) allows only "independent" directors to appoint members of a special litigation committee. Here, all Directors, including those who committed the wrongdoing, appointed members of the committee.

Second, members of the committee must be independent. Here, two members were Directors who committed the wrongdoing and the third member was a past Director who had previously engaged in similar wrongdoing.

Third, the committee's inquiry must be reasonable. Here, the committee allowed the Directors to control important aspects of its inquiry and relied upon the very corporate counsel who had approved the discriminatory practices described in the derivative claims in the first place.

Fourth, the committee must exercise business judgment and make the decision of whether to move to dismiss the derivative claims. Here, one member of the committee testified that the committee did not consider the best interest of the HOA and, as the committee report confirms, the committee did not employ business judgment to recommend dismissal. That decision was left to the Directors whose lack of independence required the appointment of a special litigation committee in the first place.

For all of those reasons, there are at least genuine issues of fact concerning whether the Directors satisfied section 16-6a-612(4) in their motion to dismiss the derivative claims. This court should vacate the order dismissing the derivative claims to allow those claims to be evaluated on their merits.

Argument

The district court dismissed the derivative claims after ruling that there is no genuine issue of fact concerning whether the Directors and members of the special litigation committee were independent. The court based its ruling on its view that (i) the relationships between the Directors and members of the committee were “casual social relationship[s]” and (ii) being named as defendants in the derivative action does not negate independence. (R.1761-64,1893:1-5.) The court also ruled that the committee had concluded, and had a reasonable basis for concluding, that “the derivative proceeding is not in the best interest of HCEII.” (R.1763.)

As demonstrated below, the district court erred in dismissing the derivative claims under section 16-6a-612(4) because the special litigation committee was not independent, as required by section 16-6a-612(4)(b)(ii), and its inquiry into whether maintenance of the derivative claims is in the best interest of the HOA was inadequate under section 16-6a-612(4)(a).

Because the mechanism for dismissing derivative claims in section 16-6a-612(4) is unusual, this brief proceeds as follows. First, it discusses the standard of review because this court has not interpreted the dismissal mechanism in section 16-6a-612. Second, it sets forth the relevant statutory language. Third, because many operative terms in section 16-6a-612 are not defined and have their origin in case law — especially Delaware case law — the brief summarizes the

history of the dismissal mechanism that became section 16-6a-612.³ Fourth, the brief addresses the three issues presented by interpreting the statute in light of that history as well as (i) commentary to the Model Nonprofit Corporation Act (“MNCA”) on which section 16-6a-612 is based and (ii) case law in jurisdictions with similar statutes.

The issues addressed are (i) which party had the burden of proving that the special litigation committee satisfied the requirements in section 16-6a-612(4)(a), something the district court never decided; (ii) whether the special litigation committee was independent under section 16-6a-612(4)(b)(ii); and, if so, (iii) whether the committee conducted a reasonable inquiry and concluded that maintenance of the derivative claims was not in the best interest of the HOA.

I. The Summary Judgment Standard Applies to Motions to Dismiss Filed Under Utah Code Section 16-6a-612(4)(a)

Courts routinely apply the summary judgment standard in adjudicating motions to dismiss derivative claims under dismissal mechanisms like the one in section 16-6a-612(4). This court should adopt the same standard, especially since the Directors applied the summary judgment standard in the district court.

As the Delaware Supreme Court⁴ has noted, because the type of motion at issue here involves control of the corporation, it is a “hybrid [motion] derived by analogy to a motion to dismiss a derivative suit based upon a voluntary

³ For reasons explained below, the issues presented here also implicate derivative claims filed on behalf of for-profit corporations under section 16-10a-740.

⁴ The Directors relied on Delaware law in the district court. (R.1405,1660.)

settlement reached between the parties and to a motion brought pursuant to Rule 41(a)(2) whereby a plaintiff unilaterally seeks a voluntary dismissal of the complaint subsequent to the filing of an answer by the defendant.” Kaplan v. Wyatt, 484 A.2d 501, 506-07 (Del. Ch. 1984). But despite its unique nature, Delaware applies “the normal burden under Rule 56 that there is no genuine issue as to any material fact and that the moving party is entitled to [judgment] as a matter of law.” Zapata Corp. v. Maldonado, 430 A.2d 779, 788 (Del. 1981).

Other states have followed Delaware in applying the summary judgment standard. Finley v. Superior Court, 80 Cal. App. 4th 1152, 1160-61 (2000) (citing numerous cases for the proposition that “courts which have considered the issue have concluded that judicial review of the independence, good faith, and investigative techniques of a special litigation committee is governed by traditional summary judgment standards”); Boland v. Boland, 31 A.3d 529, 561-63 (Md. 2011) (applying summary judgment standard); Janssen v. Best & Flanagan, 662 N.W.2d 876, 889 (Minn. 2003) (“Generally, when the committee authorized with making a business decision for the corporation is found to lack the independence needed to grant summary judgment, or where the independence is uncertain, the derivative suit proceeds on its merits.”).

This court should apply the summary judgment standard not only because it is applied in a majority of jurisdictions, but also because the Directors invited the district court to apply that standard, stating that “if there are no genuine issues of material fact regarding the committee’s independence, good faith and

investigative techniques, the derivative suit must be dismissed.” (R. 1405; see also R.1382 (“undisputed material facts show that the board members acted in good faith, with the care of ordinarily prudent persons, and in a manner reasonably believed to be in the best interests of the nonprofit corporation”).)

The Directors should not be able to argue for a different standard for the first time in this court. Will v. Engebretson & Co., 213 Cal. App. 3d 1033, 1043 (1989) (having chosen to frame its special litigation committee dismissal papers as governed by the summary judgment standard, the party was “bound to follow it in all its particulars”). Perhaps more important, the district court accepted the Directors’ invitation and applied the summary judgment standard. (R.1763 (“no genuine issues of material fact”).) This court should do the same.

If there exists a genuine issue of material fact, this court should reverse the order dismissing the derivative claims.

II. Under Section 16-6a-612, the District Court Erred in Dismissing the Derivative Claims Because There Were Genuine Issues of Material Fact Concerning Independence and the Reasonableness of the Inquiry

Utah Code section 16-6a-612 governs both how plaintiffs file derivative claims on behalf of nonprofit corporations and how their directors may seek dismissal of derivative claims without adjudicating the merits. While the statute sets forth the general mechanism for dismissing derivative claims, its language is ambiguous with regard to a number of key components. For that reason, after setting forth the procedure and standards in section 16-6a-612, this brief discusses both the origin of the dismissal process codified in section 16-6a-612,

the commentary to the model acts on which section 16-6a-612 is based, and case law interpreting similar statutes.

A. The Procedures and Standards in Utah Code Section 16-6a-612

Derivative claims are an exception to the presumption that boards of directors exercise sound business judgment in governing corporations. That presumption is embodied in the so-called “business judgment rule,” a “presumption protecting conduct by directors that can be attributed to any rational business purpose.” Dennis J. Block, et al., The Business Judgment Rule: Fiduciary Duties of Corporate Directors 18 (5th ed. 1998). Under the business judgment rule, “as long as the disinterested director(s) made an informed business decision, in good faith, without an abuse of discretion, he or she will not be liable for corporate losses resulting from his or her decision.” *Id.* at 39. Utah recognizes a version of the business judgment rule: Utah Code §16-6a-822.

1. Written Demand

Derivative claims allow members and shareholders to bring claims on behalf of the corporation against those (including its directors) who have harmed, or otherwise not acted in the best interest of, the corporation. The right to bring derivative claims is tempered to ensure that corporations are not forced to pursue claims when their merit is outweighed by the time and resources necessary to prevail. Auerbach v. Bennett, 393 N.E.2d 994, 1000-01 (N.Y. 1979). Thus, before a plaintiff can commence a derivative lawsuit, “a written demand [must be] made upon the nonprofit corporation to take suitable action.” Utah

Code §16-6a-612(3)(a)(i); see also Utah Code §16-10a-740(3)(a) (same requirement with for-profit corporations).

2. Verified Complaint

In Utah, once the demand is made a complaint may be filed (i) after the expiration of 90 days; (ii) if the directors reject the demand; or (iii) if irreparable injury would result from waiting. Id. §16-6a-612(3)(a). The complaint must be verified and allege with particularity the demand made upon the directors. Id. §16-6a-612(3)(b). And if the complaint is filed after the directors reject the demand, the complaint also must allege with particularity that (i) a majority of the board of directors were not independent or (ii) why the rejection of the demand was legally inadequate. Id. §16-6a-612(4)(d).

3. Dismissal Mechanism

The district court may stay the lawsuit to allow the directors to conduct an inquiry. Id. §16-6a-612(3)(d). The stay provides an independent person or group time to determine “in good faith, after conducting a reasonable inquiry upon which the person’s or group’s conclusions are based, that the maintenance of the derivative proceeding is not in the best interest of the nonprofit corporation.” Id. §16-6a-612(4)(a) (emphasis added).

There are three types of persons or groups who can make the subsection (4)(a) determination and recommend dismissal: (i) a majority of “independent directors present at a meeting of the board of directors, if the independent directors constitute a quorum;” (ii) a special litigation committee “consisting of

two or more independent directors appointed by a majority vote of independent directors;" or (iii) a court appointed "panel of one or more independent persons."⁵ Id. §16-6a-612(4)(b), (4)(f).

If dismissal is recommended, then the plaintiff may conduct discovery akin to Rule 56(f) that is "limited to facts relating to whether the person or group conducting the inquiry is independent and disinterested; the good faith of the inquiry; and the reasonableness of the procedures followed by the person or group conducting the inquiry." Id. §16-6a-612(3)(e) (emphasis added). Discovery does not extend to the merits of the derivative claims. Id.

4. Burden of Proof

The burden of proving compliance with subsection (4)(a) is governed by sections 16-6a-612(4)(e), (4)(f). If a court-appointed person or group makes the subsection (4)(a) determination, then "the plaintiff has the burden of proving that the requirements of Subsection (4)(a) are not met." Id. §16-6a-612(f)(ii). Otherwise, the burden is determined by whether "a majority of the board of directors consists of independent directors at the time the determination is made to reject a demand by a complainant." Id. §§16-6a-612(4)(e). If a majority is independent, the plaintiff has the burden; if a majority is not independent, then the directors must prove compliance with subsection (4)(a). Id.

⁵ The HOA requested a court appointed person, but the Directors refused. (R.235,1892:22.) Had the district court appointed someone under section 16-6a-612(f)(i), the issue here regarding independence likely would never have arisen. Brewster v. Brewster, 2010 UT App 260, ¶17 n.8, 241 P.3d 357.

5. Unanswered Questions

The language of section 16-6a-612 leaves a number of questions unanswered. First, it does not define “independent” or indicate whether the scope of the limited discovery under section 16-6a-612(3)(e) – whether the person or group was “independent and disinterested” – reveals that the “independen[ce]” required of a director in subsections (4)(a) and (4)(e) also requires the director to be disinterested. If the requirement does not include disinterestedness, then it is unclear why the plaintiff can conduct limited discovery on that issue.

Second, the language does not indicate whether the independence required to determine who has the burden of proving compliance with subsection (4)(a) is the same independence required of the person or group conducting the inquiry under subsection (4)(a). If it is the same independence, then the burden of proof determination appears to overlap with the issue on which a party has the burden, namely director independence.

Finally, the language does not indicate what constitutes a good faith and reasonable inquiry into whether the derivative claims are in the best interest of the corporation. For example, the statute does not specify what role the non-independent directors may play in the work of a special litigation committee.

Fortunately, the history of the dismissal mechanism that became section 16-6a-612 provides clear answers to those questions.

B. The Origin of Derivative Claims and Special Litigation Committees

The right to prosecute derivative claims on behalf of a corporation dates back to 1856. Dodge v. Woolsey, 59 U.S. (18 How.) 331 (1856). Directors of a corporation could defend against derivative claims under the business judgment rule. United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261, 263-64 (1917). As long as the directors' decision not to pursue or maintain the claim reflected a business judgment, the derivative claim was dismissed. Thus, for example, where shareholders filed an antitrust claim on behalf of the corporation against a competitor, dismissal in light of the business judgment of the directors was fairly straightforward. But where the derivative claim alleged self-dealing by a director, deferring to director business judgment was more complicated.

By 1934, the Securities and Exchange Commission began playing a significant role in regulating corporations. In the 1970s, the SEC enforcement division began requiring corporations to appoint independent directors to conduct internal investigations with the assistance of outside counsel. Kenneth B. Davis, Jr., The Forgotten Derivative Suit, 61 Vand. L. Rev. 387, 393-95 (2008) ("Forgotten Derivative Suit"). In some instances, the SEC required corporations to create special litigation committees to "review pending and future claims and questions of conflict of interest involving the company's officers, directors, controlling persons, and employees." Id. at 394-95.

C. Case Law Developing the Use of Special Litigation Committees

In 1976, a federal judge was presented with a detailed report of a special litigation committee that, with the assistance of outside counsel, concluded that maintenance of a derivative lawsuit was not in the best interest of the corporation. Gall v. Exxon Corp., 418 F. Supp. 508, 514 (S.D.N.Y. 1976). The court ruled that the decision of the special litigation committee fell within the business judgment rule because its members had acted in good faith and were independent of the tainted board of directors in the sense that they had not acted in an advisory capacity. Id. at 514-19. The court denied the motion, but only to permit the plaintiffs “to test the bona fides and independence of the Special Committee through discovery and, if necessary, at a plenary hearing.” Id. at 520.

The procedure approved in Gall has been adopted by nearly every jurisdiction. Forgotten Derivative Suit, at 390. Most famously, the Delaware Supreme Court adopted the dismissal procedure in Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981).⁶ Zapata recognized the value of special litigation committees in allowing corporations to maintain the business judgment rule defense where their boards are “tainted by the self-interest of a majority of its members.” Id. at 786. The court noted that “[i]t thus appears desirable to us to find a balancing point where bona fide stockholder power to bring corporate

⁶ In Delaware, and in some other states, the doctrine has been governed by case law interpreting the business judgment rule and the general authority of directors to form committees, but has never been codified. Id. at 782; Finley, 80 Cal. App. 4th at 1158-60.

causes of action cannot be unfairly trampled on by the board of directors, but the corporation can rid itself of detrimental litigation.” Id. at 787.

An independent special litigation committee was the answer as long as the committee – not the directors – (i) considered relevant “factors ethical, commercial, promotional, public relations, employee relations, fiscal as well as legal,” (ii) produced a “thorough written record of the investigation and its findings and recommendations,” and (iii) “cause[d] its corporation to file a pretrial motion to dismiss.” Id. at 788. Even with those protections, courts recognized that the use of special litigation committees is “[t]he only instance in American Jurisprudence where a defendant can free itself from a suit by merely appointing a committee to review the allegations of the complaint.” Lewis v. Fuqua, 502 A.2d 962, 967 (Del. Ch. 1985). Indeed, the procedure is “designed to provide a means, if warranted, to throw a derivative plaintiff out of Court before he has an opportunity to engage in any discovery whatever in support of the merits of his cause of action.” Kaplan, 484 A.2d at 509.

The “fox guarding the henhouse” nature of the process – sometimes described as “structural bias” – requires courts “to be mindful of the need to scrutinize carefully the mechanism by which directors delegate to a minority committee the business judgment authority to terminate derivative litigation, particularly when the lawsuit is directed against some or a majority of the directors.” Will, 213 Cal. App. 3d at 1043 (1989). Much like the inquiry to ensure arbitrator independence, the inquiry into the independence of special litigation

committees is important “to retain its integrity, a quality that is, in turn, essential to the utility of that process.” In re Oracle Corp. Derivative Litig., 824 A.2d 917, 940 (Del. Ch. 2003).⁷ The type of independence required is “like Caesar’s wife—above reproach.” Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1055 (Del. 2004) (quoting Lewis, 502 A.2d at 967).

Because of the importance of independence, the burden to demonstrate independence shifts from the plaintiff to the directors when the claims move from a pre-suit demand to a post-suit motion to dismiss. Independence determinations at the post-suit motion to dismiss stage involve “diametrically-opposed burdens” from those in the pre-suit demand context. Beam, 845 A.2d at 1055. In the pre-suit demand context, the plaintiff must rebut the presumption in favor of the board’s independence by establishing in a verified complaint “a reasonable doubt that a majority of the board could have acted independently.” Id. at 1048-49. In the post-suit context involving a special litigation committee, the directors carry “the burden of proving independence, good faith and a reasonable investigation, rather than presuming independence, good faith and reasonableness.” Zapata, 430 A.2d at 788.

⁷ See also London v. Tyrrell, Civ. No. 3321-CC, 2010 WL 877528, at *16 (Del. Ch. Mar. 11, 2010) (“members should be selected with the utmost care to ensure that they can, in both fact and appearance, carry out the extraordinary responsibility placed on them”); Principles of Corporate Governance §7.10 cmt. d (“[G]iven the possible perception that board members may be consciously or unconsciously partial to the interests of their colleagues who are defendants, some judicial oversight of this process is important in order to maintain public and investor confidence in the integrity of corporate governance.”).

In a second holding that was not universally followed, Zapata held that, even if the directors establish good faith and independence as a matter of law, the court must “determine, applying its own independent business judgment, whether the motion should be granted.” Id. at 789. The New York Court of Appeals had rejected that view and held that courts should not review the business judgment of the committee as long as its independence is beyond question. Auerbach v. Bennett, 393 N.E.2d 994 (N.Y. 1979). All courts agree, however, on the importance of independence and that the directors had the burden of demonstrating independence and good faith in the post-suit context. Drilling v. Berman, 589 N.W.2d 503, 508 (Minn. Ct. App. 1999) (outlining the difference between the Auerbach approach and the Zapata approach).

What emerges from the early case law is the following. A plaintiff must make a pre-suit demand. If the demand is rejected, the plaintiff must establish in a verified complaint that a majority of the board of directors who rejected the demand was not independent or that the rejection was wrongful. The directors then can delegate to an independent special litigation committee the authority to evaluate whether maintenance of the derivative claims is in the best interest of the corporation. If the committee recommends dismissal, the directors must show that there is no disputed issue of fact concerning whether the committee

- (i) was independent, meaning “like Caesar’s wife – above reproach;”
- (ii) conducted a reasonable inquiry; and (iii) acted in good faith. The directors

also must show that the committee had fully delegated (not advisory) authority to conduct its inquiry and make its dismissal recommendation.

D. The MBCA, the MNCA, and Case Law Interpreting Their Provisions Reveal That the District Court Misinterpreted Utah Code Section 16-6a-612

Beginning in 1992, the Model Business Corporations Act (“MBCA”) codified the special litigation committee procedures and standards. The Model Nonprofit Corporations Act (“MNCA”) followed suit in 2000. A copy of the various versions of the MBCA and MNCA are at Addendum B. The comments to both the MBCA and MNCA – which are virtually identical – shed more light on (i) the burden of proof in section 16-6a-612(4)(e), (ii) what constitutes independence for a special litigation committee under section 16-6a-612(4)(b)(ii), and (iii) what is a good faith, reasonable inquiry under section 16-6a-612(4)(a).

1. The Verified Complaint’s Allegations That a Majority of Directors Were Not Independent Shifted the Burden of Proof to the Directors

Like the Delaware procedure, section 16-6a-612 contemplates that a plaintiff will make a demand on the board of directors before filing a derivative lawsuit. If the demand is rejected, then the verified complaint must establish that either a majority of the board of directors lacked independence or their rejection did not comply with subsection (4)(a). Utah Code §16-6a-612(4)(d). If the complaint establishes that a majority of directors lacked independence, then “the corporation has the burden of proving that the requirements of Subsection (4)(a) are met.” *Id.* §16-6a-612(4)(e)(i).

The commentary to the MNCA confirms that the verified complaint is where a lack of independence is established for determining the burden of proof. That commentary explains that the burden shifting provisions in the MNCA were designed in “response to concerns of structural bias” in the dismissal mechanism. MNCA 13-17 (2008). As courts have noted, “[i]t is not cynical to expect that [special litigation] committees will tend to view derivative actions against the other directors with skepticism.” Joy v. North, 692 F.2d 880, 888 (2d Cir. 1982). To solve that problem, the directors bear the burden “where a majority of directors is not independent, and the determination is made by [a special litigation committee] specified in subsection [(4)](b)(ii).” MNCA 13-17.

The commentary notes that the burden shifting procedures are not identical to those in Delaware law because, unlike Delaware law, under the MNCA there are no “demand-excused situation[s]” that allow plaintiffs to bypass the demand procedure by preemptively pleading “particularized facts that create a reasonable doubt that a majority of directors at the time [a] demand would be made are independent or disinterested.” MNCA 13-14. In Delaware, when a plaintiff establishes a lack of independence in the verified complaint—whether to excuse the demand or in response to its rejection—the directors may reassert the right to control the litigation by forming a special litigation committee. But the directors then “bear the burden of proving the independence of the committee, the reasonableness of its investigation, and the reasonableness of the bases of its decision reflected in the motion.” MNCA 13-14 to 13-15.

Under the MNCA, the plaintiff must always make a demand. MNCA §13.03 & 13-16. Despite that difference, the MNCA retained the distinction under Delaware law by assigning to “the plaintiff the threshold burden of alleging facts establishing that a majority of the board is not independent.” MNCA 13-16. Thus, it is in the verified complaint that a plaintiff establishes a lack of independence of the majority of the board, which operates to determine which party has the burden of proving the independence of the special litigation committee and “the propriety of [its] inquiry and determination.” MNCA 13-16.

Here, the operative verified complaint alleges that each Director was engaged in self-dealing and personally benefitted from the decisions concerning which roads to build and maintain within the HOA. (R.1056 (“the roads located near the homes owned by the Board’s members are maintained and improved with monies paid by all members of the Association, while other roads are left to deteriorate and have been rendered impassable due to intentional neglect”); R.1562-63 (Directors have burden of proving compliance with subsection (4)(a).)

Therefore, the Directors bore the burden of proving compliance with subsection (4)(a), something the district court refused to acknowledge. (R.1761-64.) Ultimately, however, the burden of proof has little significance given the motion papers filed in this case because the HOA had to demonstrate only a disputed issue of material fact concerning compliance with subsection (4)(a). Thus, regardless of which party has the burden in this case, disputed issues of fact precluded the dismissal of the derivative claims.

2. A Genuine Issue of Material Fact Exists With Regard to Whether the Special Litigation Committee Was Independent Under Section 16-6a-612(4)(b)(ii)

Section 16-6a-612(4)(b)(ii) governs special litigation committees. That section requires “a majority vote of a committee consisting of two or more independent directors appointed by a majority vote of independent directors present at a meeting of the board of directors.” Utah Code §16-6a-612(4)(b)(ii) (emphasis added). Thus, the members of a special litigation committee can be appointed only by independent directors and the committee itself must consist of at least two independent directors. If there are not two independent directors, then only a court-appointed group can determine whether maintenance of the derivative claims is in the best interest of the corporation. *Id.* §16-6a-612 (4)(f).

While section 16-6a-612 does not define “independent,” it does specify what does not, by itself, negate independence:

None of the following by itself causes a director to be considered not independent for purposes of this section:

- (i) the nomination or election of the director by persons
 - (A) who are defendants in the derivative proceeding; or
 - (B) against whom action is demanded;
- (ii) the naming of the director as
 - (A) a defendant in the derivative proceeding; or
 - (B) a person against whom action is demanded; or
- (iii) the approval by the director of the act being challenged in the derivative proceeding or demand if the act resulted in no personal benefit to the director.

Utah Code §16-6a-612(4)(c) (emphasis added). The key language is “by itself.”

The commentary to the MNCA explains that the section was designed to reject “the concept that the mere appointment of new directors [to the board, not the special litigation committee] by the non-independent directors makes the new directors not independent in making the necessary determination because of an inherent structural bias.” MNCA 13-12. The commentary also explains that “the mere fact that a director has been named as a defendant or approved the action being challenged does not cause the director to be considered not independent.” Id. The commentary thus makes clear that courts should assess “actual bias” instead of applying a per se rule that a director is not independent if the director (i) is appointed by a non-independent director, (ii) is a defendant, or (iii) approved the challenged action (without personal gain). Id.

That interpretation has been adopted in other jurisdictions. For example, the Wisconsin Supreme Court explained that, even though those three factors that are not, by themselves, enough to negate independence, courts should “give weight to these factors; [as] the statute simply states that the presence of one or more of these factors is not solely determinative of the issue of whether a director is independent.” Einhorn v. Culea, 612 N.W.2d 78, 86 (Wis. 2000).

Thus, in this case the district court erred in refusing to consider the fact that both the Directors who appointed members of the special litigation committee and members of the special litigation committee were defendants to the derivative claims and approved the acts at issue—i.e., the discriminatory funding of roads to favor the Directors’ properties. (R.1561,1893:3-4.) The

district court instead should have determined whether that evidence, coupled with additional evidence of actual bias described below, created a disputed issue of fact concerning independence.

a. The Current Versions of the MBCA and the MNCA Specify What Constitutes Independence for a Special Litigation Committee

Despite the fact that most cases involving special litigation committees focus on independence, early versions of the MNCA did not define the term “independent.” MNCA §§1.40, 13.05. The Utah Code also uses the phrase “independent director” and similarly does not define “independent.” 2006 Utah Laws Ch. 228, §2 (West) (S.B. 84) (amending section 16-6a-612 to introduce the term “independent director[]”); 2000 Utah Laws Ch. 130, §1 (West) (H.B. 86) (amending section 16-10a-740 to introduce the term “independent director[]”).⁸

In 2005, the MBCA, but not the MNCA, began using the phrase “qualified director” instead of “independent director” and defined the term “qualified.” MBCA §7.44. A “qualified director,” under the revised MBCA, is a director who “does not have (i) a material interest in the outcome of the proceeding, or (ii) a material relationship with a person who has such an interest.” MBCA §1.43(a)(1) (2011). A “material interest” is “an actual or potential benefit or detriment (other than one which would devolve on the corporation or the shareholders generally)

⁸ The dismissal procedure in Utah Code section 16-10a-740 (Utah Revised Business Corporation Act) came from the MBCA in 2000, and the dismissal procedure in section 16-6a-612 (Utah Revised Nonprofit Corporation Act) came from section 16-10-a-740, as the MNCA did not contain the dismissal mechanism until 2008. MNCA §13.05.

that would reasonably be expected to impair the objectivity of the director's judgment when participating in the action to be taken." Id. §1.43(b)(2). And a "material relationship" is "a familial, financial, professional, employment or other relationship that would reasonably be expected to impair the objectivity of the director's judgment when participating in the action to be taken." Id. §1.43(b)(1).

Use of the phrase "qualified director" was intended to distinguish the more common definition of "independent director" as a director who is not also an officer or employee of the corporation. MBCA §1.43 cmt. 2; see also Oracle, 824 A.2d at 941 n.62 (quoting NASD Rules 4200 & 4350). Like the MBCA, the MNCA makes clear that "independent" does not have that more common meaning: "The concept of an independent director is not intended to be limited to nonofficer or 'outside' directors but may in appropriate circumstances include directors who are also officers." MNCA §13.05 cmt. 1.⁹

⁹ There is some irony, then, in the fact that the only Utah legislative history concerning the meaning of the phrase "independent director" came in the 2000 floor debate on section 16-10a-740, when Senator Valentine explained that "independent director" carries the same meaning as the more common definition. He explained that the bill had

a mechanism where a majority of board of directors who are independent members of the board of directors may make an action and then stop the derivative action. They may make the action that the people who were the shareholders wanted. Now what are independent board members and what are non-independent board members. An independent board member is one that is outside of the organization. He or she is not an officer, is not an employee, doesn't receive any compensation from the corporation with the exception of the compensation for serving as a director of the corporation. . . . In those kinds of

The comments to the MBCA explained the change in terminology as clarifying, not substantive:

Although the term “qualified director” embraces the concept of independence, it does so only in relation to the director’s interest or involvement in the specific situations to which the definition applies. Thus, the term “qualified director” is distinct from the generic term “independent director” used in section 8.01(c) of the Act to describe a director’s general status. As a result, an “independent director” may in some circumstances not be a “qualified director,” and vice versa.

MBCA §1.43 cmt.2.

Unlike the MBCA, the MNCA does not employ the phrase “qualified director.” MNCA §13.05. But it now defines “independent director” as the MBCA defines “qualified director.” Id. The MNCA definition is as follows:

A person is independent for purposes of this section if the person does not have (1) a material interest in the outcome of the proceeding, or (2) a material relationship with a person who has such an interest.

cases, you can look to that independent board to determine whether the action proposed by the shareholder is proper or not proper and that is what [the bill] does; it allows us a way to alleviate the litigation in a derivative action context by the independent board’s action.

Senate Floor Debate, H.B. 86, 53rd Utah Leg., 2000 Gen. Sess. (Feb. 28, 2000) (statement of Sen. John L. Valentine). Senator Valentine’s definition finds support in some case law holding that “independent” means outside directors, i.e., “directors who were not also officers or employees of [the corporation].” In re Abbott Labs. Derivative S’holders Litig., 325 F.3d 795, 801 (7th Cir. 2003). If that definition applies here, then none of the Directors were independent, as they were all officers of the HOA.

MNCA §13.05(f).¹⁰ In fact, the definition section of the MNCA expressly indicates that its definitions of “material interest” and “material relationship” are “[p]atterned after Model Business Corporation Act.” MNCA §1.40(34), (35) (citing MBCA §1.43(b)(1), (b)(2)).

The clarifications in the MBCA and MNCA should apply to the interpretation of Utah Code sections 16-6a-612 and 16-10a-740. Both sections of the Utah Code allow limited discovery on whether the person or group conducting the subsection (4)(a) determination is “independent and disinterested.” Utah Code §§16-6a-612(3)(e)(i)(A), 16-10a-740(3)(e)(i)(A). And the comments to the most recent version of the MNCA make clear that the new definition clarifies that being disinterested was part of being independent:

The decisions that have examined the qualifications of directors making the determination have required that the directors be both “disinterested” in the sense of not having a personal interest in the transaction being challenged (as opposed to a benefit which devolves upon the corporation or all shareholders generally) and “independent” in the sense of not being influenced in favor of the defendants by reason of personal or other relationships. See, e.g., Aronson v. Lewis, 743 A.2d 805, 812-16 (Del. 1984). Only the word ‘independent’ has been used in Section 13.05(b) because it is believed that a person who has an interest in the transaction would not be independent.

MNCA §13.05 cmt. 1.

¹⁰ The comments to uniform acts are “the only thing that could be described as legislative history” of the Utah provisions adopting a uniform act. Schurtz v. BMW of N. Am., Inc., 814 P.2d 1108, 1113 (Utah 1991); McLaughlin v. Schenck, 2009 UT 64, ¶35, 220 P.3d 146, 160.

The American Law Institute's Principles of Corporate Governance is consistent with the definitions in the MBCA and MNCA.¹¹ It defines "interested" to apply to directors who (i) are a party to the transaction of conduct, (ii) have a business' financial or familial relationship with a party to the transaction or conduct, (iii) have a material pecuniary interest in the transaction or conduct, or (iv) are subject to a controlling influence by a party to the transaction or conduct or a person who has a material pecuniary interest in the transaction or conduct. Principles of Corporate Governance §§1.23, 7.09 (2012).¹² A copy of the full definition is at Addendum B.

This court should accept the clarifying definition in the MNCA and hold that directors are independent if they are disinterested in the litigation in the sense that they have no material interest in its outcome or material relationship with a person with such an interest. Under section 16-6a-612(4)(b)(ii), the

¹¹ This court may rely upon such treatises when interpreting corporate law. R & R Indus. Park, L.L.C. v. Utah Prop. & Cas. Ins. Guar. Ass'n, 2008 UT 80, ¶28, 199 P.3d 917 ("Where legislative history is absent or unclear, model codes can be a useful resource in determining the intent of the legislature and underlying policy issues."); see also McLaughlin, 2009 UT 64, ¶35 (using the comments to the MBCA to interpret the term "transaction"); Aurora Credit Servs., Inc. v. Liberty West Dev., Inc., 970 P.2d 1273, 1280 (Utah 1998) (relying on the Principles of Corporate Governance).

¹² The ALI's definition of "interested" is narrower, as it disqualifies a director (or an associate of the director) who is a named party, but otherwise is similar to the definitions for "qualified" in the MBCA and "independent" in the MNCA. Compare Principles of Corporate Governance §1.23 ("reasonably . . . expected to [adversely] affect the director's . . . judgment") with MBCA §1.43(b) ("reasonably . . . expected to impair the objectivity of the director's judgment") and MNCA §1.40(34), (35) ("reasonably . . . expected to impair the objectivity of [the director's] judgment").

directors who appoint members of the special litigation committee¹³ and the directors who serve on the committee must be independent. As demonstrated next, the case law interpreting “independence” in similar statutes is in accord.

b. Case Law Confirms What Constitutes Independence for a Special Litigation Committee

A number of courts have articulated factors to consider in determining whether members of a special litigation committee are independent. For example, the Wisconsin Supreme Court considers factors consistent with the current definition in the MNCA, but expressly sets forth as a factor whether corporate counsel or independent counsel assisted the special litigation committee. Einhorn, 612 N.W.2d at 89-90;¹⁴ Davidowitz v. Edelman, 153 Misc.2d 853, 857 (N.Y. Sup. Ct. 1992) (refusing to defer to committee’s recommendation in part because its counsel was chosen by corporate counsel); In re Par Pharm., Inc. Derivative Litig., 750 F. Supp. 641, 647 (S.D.N.Y. 1990) (refusing to defer to committee recommendation in part because it failed to retain outside counsel);

¹³ To illustrate the importance of independent directors appointing members of the special litigation committee, in Iowa, if a majority of the board is not independent, only the court can appoint the independent committee. Miller v. Register & Tribune Syndicate, Inc., 336 N.W.2d 709, 718 (Iowa 1983).

¹⁴ The factors are: (1) “status as a defendant and potential liability;” (2) “participation in or approval of the alleged wrongdoing or financial benefits from the challenged transaction;” (3) “past or present business or economic dealings with an individual defendant;” (4) “past or present personal, family, or social relations with individual defendants;” (5) “past or present business or economic relations with the corporation;” (6) “[t]he number of members on [the] special litigation committee;” and (7) “[t]he roles of corporate counsel and independent counsel.” Einhorn, 612 N.W.2d at 89-90.

Principles of Corporate Governance §7.09 cmt. d (although at times “the committee may retain the counsel who earlier served the board to advise it further,” it may not do so “if the earlier inquiry and evaluation were conducted or guided by interested directors”).

In Tennessee, the list of factors is similar, but includes whether the special litigation committee itself was independent of the directors in the sense that the committee – not the directors – made the final determination concerning whether to move to dismiss the derivative claims. Lewis v. Boyd, 838 S.W.2d 215, 224 (Tenn. Ct. App. 1992);¹⁵ see also Janssen, 662 N.W.2d at 884 (“The key element is that the board delegates to a committee of disinterested persons the board’s power to control the litigation. A mere advisory role of the special litigation committee fails to bestow a sufficient legitimacy to warrant deference to the committee’s decision by the court.”); Par Pharm., Inc. Derivative Litig., 750 F. Supp. at 647-48 (no deference to business judgment of special litigation committee if it makes only a recommendation to the board); Greenfield v. Hamilton Oil Corp., 760 P.2d 664, 668 (Colo. App. 1988) (“to be entitled to judicial deference, the committee must be given the ultimate power of decision or, at the least, any recommendation made by the committee must be finally passed upon only by other disinterested members of the board of directors”); cf.

¹⁵ The factors are: “(1) the size of the committee, (2) the committee members’ relationship with the corporation’s officers and directors, (3) the committee members’ qualifications and experience, . . . (4) the scope of the committee’s authority, and (5) the committee’s autonomy from the directors, officers, and corporate counsel.” Boyd, 838 S.W.2d at 224.

Swenson v. Thibaut, 250 S.E.2d 279, 298 (N.C. Ct. App. 1978) (involvement of interested directors in the decision to dismiss negated good faith under business judgment rule).¹⁶

The Minnesota Supreme Court has attempted to compile all of the factors considered by various courts: “(1) whether the members are defendants in the litigation; (2) whether the members are exposed to direct and substantial liability; (3) whether the ‘members are outside, non-management directors’; (4) whether the members were on the board when the alleged wrongdoing occurred; (5) whether the ‘members participated in the alleged wrongdoing’; (6) whether the members approved conduct involving the alleged wrongdoing; (7) whether the members or their affiliated firms ‘had business dealings with the corporation other than as directors’; (8) whether the members ‘had business or social relationships with one or more of the defendants’; (9) whether the members received advice from independent counsel or other independent advisors; (10) the severity of the alleged wrongdoing; and (11) the size of the committee.”

In re UnitedHealth Grp. Inc. S’holder Derivative Litig., 754 N.W.2d 544, 560 n.11

¹⁶ The ALI’s official commentary states that although “§ 7.09 does not preclude a committee from reporting back to the board with its determinations for approval by the board as a whole,” there are two important requirements for corporations that do. Principles of Corporate Governance §7.09 cmt. d. First, the vote on the report must take place “minus any members whose status as defendants in the action would impair their objectivity.” *Id.* (emphasis added). Second, “during the period that any committee is conducting its evaluation, care should be taken to minimize the contacts between the committee and the remainder of the board with respect to the committee’s deliberations.” *Id.* (emphasis added).

(Minn. 2008).¹⁷ Under any of those tests, the special litigation committee in this case lacked independence.

c. The Special Litigation Committee Was Not Independent Under Section 16-6a-612(4)(b)(ii)

Under the general definition of “independent” in the MNCA and the more detailed list of factors relevant to determining independence in the case law — as well as under the more strict definition of independence under Delaware law, “like Caesar’s wife, be above reproach”, Lewis, 502 A.2d at 967 — the special litigation committee here was not independent. At the very least, a genuine issue of fact exists concerning its independence.

(i) The Special Litigation Committee Was Not Independent Under the MNCA

Under the MNCA, a person is independent “if the person does not have (1) a material interest in the outcome of the proceeding, or (2) a material relationship with a person who has such an interest.” MNCA §13.05(f). Under that definition, neither the directors who appointed the members of the special litigation committee nor the members of the committee were independent.

¹⁷ Courts routinely find that special litigation committees lack independence based upon such factors. Where two members of a special litigation committee had to serve on the board of directors with the defendant to the derivative claims, the committee lacked independence even though it had hired outside counsel. McDonough v. Americom Int’l Corp., 905 F. Supp. 1016, 1021 (M.D. Fla. 1995). Where the members of a committee were not only defendants but also could realistically face liability, they were not independent. Kloha v. Duda, 226 F. Supp. 2d 1342, 1344 (M.D. Fla. 2002). In some cases, a “prior affiliation with the corporation” is enough to negate independence. Hasan v. Clevetrust Realty Investors, 729 F.2d 372, 379 (6th Cir. 1984).

Each Director owns a lot within the HOA, and each Director benefitted from and participated in the decisions concerning which roads to build and maintain. (R.374,1056-57,1446,1448-49,1561.) Each Director engaged in “self-dealing and favoring services to and improvements benefitting” his own property. (R.1561.) And all Directors participated in the election of members of the special litigation committee at one of the board’s regular meetings. (R.1428.)

The members of the special litigation committee also lacked independence because each of them—Ms. Johnson, Mr. Sarra, and Mr. Wilson—owns a lot within HCEII that has benefitted from preferential treatment. (R.374,1561,1564.) Each member of the special litigation committee has a material interest in the past discriminatory allocation of road maintenance resources and whether those resources continue to be used in the same discriminatory manner. Under the MNCA definition, then, no Director—those who appointed members to the special litigation committee or those on the committee—was independent. That alone was sufficient to defeat the motion to dismiss in this case.

The language in section 16-6a-612(4)(c) confirms this result. That section states that a director’s approval “of the act being challenged in the derivative proceeding” does not “by itself” result in the director’s lacking independence “if the act resulted in no personal benefit to the director.” Utah Code §16-6a-612(4)(c)(iii). The clear implication of that language is that where, as here, the act did result in a personal benefit to the director, that fact “by itself” is sufficient to

indicate a lack of independence. Because all Directors lacked independence, the district court erred in dismissing the derivative claims.

**(ii) The Special Litigation Committee Was Not
Independent Under Multi-Factor Tests
Articulated in the Case Law**

The result is no different under the various lists of factors concerning independence in the case law. In fact, every factor listed in those cases indicates a lack of independence here. Consider each set of factors in turn.

The first set of independence factors includes those that section 16-6a-612 and the MNCA consider insufficient, by themselves, to negate independence—whether the Directors are defendants and whether the directors approved the acts being challenged in the derivative claims. UnitedHealth Grp. Inc., 754 N.W.2d at 560 n.11; Einhorn, 612 N.W.2d at 89. Again, while those factors, by themselves, do not indicate a lack of independence, they are relevant to the independence determination. Here, all Directors are defendants and all Directors participated in the acts, i.e., the decisions concerning which roads to build and maintain. (R.1556,1561,1564.) And two members of the special litigation committee were Director of Roads (Ms. Johnson) and Director of Legal (Mr. Sarra), during which time they were intimately involved in such decisions. (R.437,445-46,451,1519-20.) The third member of the special litigation committee, Mr. Wilson, was a director during the 1990s when the HOA faced the same legal issues concerning Area D roads. (R.410,441,1519.)

A second independence factor is whether the directors were outside, non-management directors. UnitedHealth Grp. Inc., 754 N.W.2d at 560 n.11. Here, all of the Directors, including the two who served on the special litigation committee, were inside, management directors. All Directors own property within the HOA. (R.374,1056,1561.) Ms. Johnson was Director of Roads. (R.435.) Mr. Sarra was Director of Legal. (Id.) Mr. Emmer was Director of the Architectural Control Committee and President of the HOA. (R.435,440,444-45,455,459,461,500.) Ms. Dean was Director of Community Affairs. (R.455,459,461,500.)

A third set of independence factors includes (i) whether the directors were on the board when the wrongdoing occurred, (ii) whether the directors participated in the alleged wrongdoing, and (iii) whether the directors approved of the conduct involved in the wrongdoing. UnitedHealth Grp. Inc., 754 N.W.2d at 560 n.11; Einhorn, 612 N.W.2d at 89. Here, all Directors were on the board when it made the discriminatory decisions concerning road maintenance, participated in those decisions, and approved the conduct that constituted the wrongdoing. (R.1556,1561,1564.) And the third member of the special litigation committee was a past director who participated in and approved of the same types of decisions. (R.410,441,1519.)

A fourth independence consideration is whether the directors had business dealings with the corporation. UnitedHealth Grp. Inc., 754 N.W.2d at 560 n.11; Einhorn, 612 N.W.2d at 89. Here, all Directors own lots in the HCEII and served

in management capacities within the HOA. (R.374,435,455,1056.) In addition, Mr. Wilson was employed by Sunrise Engineering, Inc., a company the Directors hired in the past to work on HCEII's roads and that continues to deal with road maintenance projects. (R.446,1579-80.)

A fifth factor is whether a director has a social relationship with the tainted directors. UnitedHealth Grp. Inc., 754 N.W.2d at 560 n.11; Einhorn, 612 N.W.2d at 89. Here, the district court acknowledged the social relationship Mr. Wilson had to the tainted Directors, but found it insignificant. (R.1734.)

A sixth factor is whether the special litigation committee hired independent counsel or used the very corporate counsel who approved of the wrongful conduct in the first place. UnitedHealth Grp. Inc., 754 N.W.2d at 560 n.11; Einhorn, 612 N.W.2d at 89-90. Here, the report of the special litigation committee was the result of a collaboration among the committee members, the HOA's attorney (Mr. Lundgren), and the most tainted Director (Mr. Emmer). (R.333-67,1508.) During its inquiry, the special litigation committee not only used the corporate counsel who approved of the discriminatory practices, (R.1448 ("Howard Lundgren's verbal advice to the Board was that the Board was within its rights to manage the road maintenance projects according to a consistent business plan")), but expressly relied upon the legal opinions of that counsel during its inquiry without doing any independent investigation. (R.1447.) For example, the report repeatedly states that "[w]here an issue results in a conflicting interpretation of the law between Attorneys, the Board's most

responsible option is to act according to the option of their legal counsel.”

(R.1447,1451,1455,1461.)

A seventh factor is whether the wrongdoing is severe. UnitedHealth Grp. Inc., 754 N.W.2d at 560 n.11. Here, while the wrongdoing may not be severe in the abstract, because the vast majority of the HOA budget is allocated to road maintenance, the wrongful discrimination in road maintenance is severe in practice. Most of the assessments paid by residents and lot owners of HCEII are used for road maintenance, i.e., the 2009-10 proposed budget shows that over 97% of the HOA’s non-water system maintenance budget was devoted to road maintenance. (R.387,464,1493.) And the roads leading to Plaintiffs’ lots are not just unmaintained, but at this point are impassible except on foot, on horseback, or via ATV. (R.49-51,441,1056-57,1444.)

An eighth factor is the size of the special litigation committee. UnitedHealth Grp. Inc., 754 N.W.2d at 560 n.11; Boyd, 838 S.W.2d at 224; Einhorn, 612 N.W.2d at 89-90. Here, the committee had three members, two current Directors and one former director. If the committee had five members and only one tainted member, then the size may mitigate the problem. But the size of the committee cannot mitigate the problem here.

A ninth factor is whether the special litigation committee operates independently from the tainted directors, i.e., the board delegates full authority to conduct the inquiry and determine whether to move to dismiss the derivative

claims.¹⁸ Janssen, 662 N.W.2d at 884; Boyd, 838 S.W.2d at 224. Here, there was no such delegation, and the committee did not recommend dismissal. (R.1431-64.) Instead, the very Directors (including Mr. Emmer) who determined that a special litigation committee was needed made the final determination concerning whether to instruct counsel to move to dismiss the derivative claims.¹⁹ (R.813.)

All of the factors courts use to assess independence indicate that the special litigation committee here was not independent under section 16-6a-612(4)(b)(ii). At the very least, genuine issues of fact exist concerning independence, which is enough to defeat the motion to dismiss. As one court put it, courts must “be mindful of the need to scrutinize carefully the mechanism by which directors delegate to a minority committee the business judgment authority to terminate derivative litigation, particularly when the lawsuit is directed against some or a majority of the directors.” Will, 213 Cal.App.3d at 1043-44. The district court here failed to do that. This court should reverse so the derivative claims can be adjudicated on their merits.

¹⁸ “The key element is that the board delegates to a committee of disinterested persons the board’s power to control the litigation. A mere advisory role of the special litigation committee fails to bestow a sufficient legitimacy to warrant deference to the committee’s decision by the court.” Janssen v. Best & Flanagan, 662 N.W.2d 876, 884 (Minn. 2003).

¹⁹ The procedure followed by Mr. Emmer is exactly backwards. Special litigation committees are appointed to prevent interested members of a board from taking a decision making role in recommending dismissal of a claim. Oracle, 824 A.2d at 940 (the special litigation committee process “presents an opportunity for a board that cannot act impartially as a whole to vest control of derivative litigation in a trustworthy committee of the board – i.e., one that is not compromised in its ability to act impartially.”).

III. The Committee Did Not Conduct a Reasonable Inquiry Because It Failed To Consider What Was In the Best Interest of the HOA and Did Not Recommend Dismissal as Required Under Section 16-6a-612(4)(a)

The district court also erred in dismissing the derivative claims because genuine issues of material fact exist concerning whether the special litigation committee satisfied the requirements in section 16-6a-612(4)(a). Those requirements include that the committee (i) act in good faith in conducting a reasonable inquiry and (ii) determine in its business judgment whether maintenance of the derivative claims is in the best interest of the HOA. Utah Code §16-6a-612(4)(a). The special litigation committee here failed in both tasks.

A. The Special Litigation Committee Inquiry Was Not Reasonable

The special litigation committee's inquiry was not reasonable. In determining whether the inquiry was reasonable, courts examine "(1) the length and scope of the investigation, (2) the committee's use of independent counsel or experts, (3) the corporation's or the defendants' involvement, if any, in the investigation, and (4) the adequacy and reliability of the information supplied to the committee." Drilling v. Berman, 589 N.W.2d 503, 506 (Minn. Ct. App. 1999); see also Lewis v. Boyd, 838 S.W.2d 215, 224 (Tenn. Ct. App. 1992) (same).

Here, as stated above, the committee did not use independent counsel and allowed the tainted Directors to participate and guide their investigation. Supra Facts II; infra Arg. III.B. In addition, the interviews conducted by the special litigation committee undermined the reliability of the information gathered by the committee. In the interviews, committee members often testified as to their

version of the events, led the witnesses based on their recollection of the events, or debated with witnesses as to the merits of the derivative claims. (R.757 (Wilson stated why a road was closed by the County); R.759-63 (Wilson and Johnson interject facts learned during their involvement with the HOA and Johnson directs questions to the “combined memory of all [of] us”); R.764,766 (Johnson testifies about the interviewee’s landscaping); R.769-72 (Johnson testifies about various rules for unincorporated areas); R.780 (Johnson explains the HOA’s handling of a nuisance near the interviewee’s property); R.792-93 (Johnson and Wilson argue with a Plaintiff about cost estimates for improving roads); R.797-98 (Wilson testifies about road conditions near his lot); R.799 (Johnson testifies as to how roads were funded in the 1990s); R.801 (Wilson offers his interpretation of HOA policies in light of events in the 1990s); R.802 (Wilson testifies as to why a hydrant and water line were put on one Plaintiff’s property); R.806-08 (Wilson and Johnson testify as to their experience with the County’s zoning regulations).

The inquiry was not conducted in a manner to ensure an independent determination of whether maintenance of the derivative claims is in the best interest of the HOA.

B. The Special Litigation Committee Did Not Use Business Judgment to Conclude That Maintenance of the Derivative Claims Is Not In the Best Interest of the HOA

The special litigation committee also failed to perform the very task it is given under section 16-6a-612(4)(a) – using business judgment to determine

whether dismissal of the derivative claims is in the best interest of the corporation. As Zapata explained, the special litigation committee should (i) consider relevant “factors ethical, commercial, promotional, public relations, employee relations, fiscal as well as legal,” (ii) produce a “thorough written record of the investigation and its findings and recommendations,” and (iii) “cause its corporation to file a pretrial motion to dismiss.” Zapata, 430 A.2d at 788. The special litigation committee failed in all three ways.

First, as outlined above the committee failed to make any recommendation concerning dismissal, let alone “cause” the filing of the motion to dismiss, as required under the case law.²⁰ (R.1431-64.) Instead, the Directors (including Mr. Emmer) made that final determination. (R.813.)

Second, the special litigation committee made no best interest determination in its report. (R.1431-64.) Instead, the report makes fourteen “observations” and three “recommendations,” none of which concern the best interest of the HOA. (Id.) In fact, Mr. Wilson – chair of the committee – admitted at his deposition that he never evaluated whether “it would be in the best interest of the [HOA] to pursue a claim against the Board for failing to maintain all of [HCEII’s] roads[.]” (R.1584.) That is confirmed by the fact that the committee’s report – attached at Addendum D – reveals no consideration of “factors ethical, commercial, promotional, public relations, employee relations, fiscal as well as legal.” Zapata, 430 A.2d at 788.

²⁰ Zapata, 430 A.2d at 788; Janssen, 662 N.W.2d at 884.

Third, the special litigation committee did not use business judgment in its inquiry, but instead performed a legal analysis of the derivative claims based upon the advice of the very corporate counsel who approved the wrongful conduct in the first place. (R.1447.) When a special litigation committee provides only legal opinions, its recommendations do not deserve deference under the business judgment rule. Janssen, 662 N.W.2d at 888-89 (special litigation committee provided a legal, not business, opinion concerning the likelihood of success of the derivative claims). Here, the report states that its purpose is “to determine if [the claims] have merit.” (R.1433.) And the recommendations in the report merely provide legal analysis. (R.1437,1447,1450,1456.) The report, and therefore the work of the committee, was inadequate under subsection (4)(a).

For all of those reasons, there is at least a genuine issue of fact concerning the adequacy of the special litigation committee’s inquiry and whether it performed its task under section 16-6a-612(4)(a). This court should reverse.

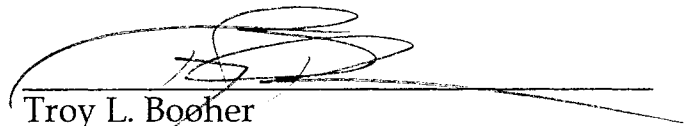
Conclusion

The Directors who appointed members of the special litigation committee were not independent, as required under section 16-6a-612(4)(b)(ii). The committee members themselves also were not independent as required under section 16-6a-612(4)(b)(ii). In addition, the committee’s inquiry was tainted, as it never exercised business judgment to determine whether maintenance of the derivative claims is in the best interest of the HOA, as required under section 16-6a-612(4)(a).

For all of those reasons, this court should reverse the order dismissing the derivative claims and mandate that they be adjudicated on their merits. Janssen, 662 N.W.2d at 890 (no second bite on remand when an order granting a motion to dismiss is reversed).

DATED this 21st day of August 2012.

ZIMMERMAN JONES BOOHER LLC



Troy L. Booher
Clemens A. Landau
Attorneys for Plaintiffs/Appellants

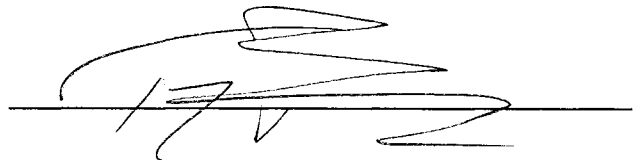
Certificate of Compliance With Rule 24(f)(1)

I hereby certify that:

1. This brief complies with the type-volume limitation of Utah R. App. P. 24(f)(1) because this brief contains 13,925 words, excluding the parts of the brief exempted by Utah R. App. P. 24(f)(1)(B).

2. This brief complies with the typeface requirements of Utah R. App. P. 27(b) because this brief has been prepared in a proportionally spaced typeface using Microsoft Word 2010 in 13 point Book Antiqua.

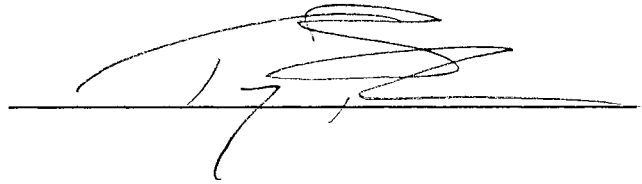
DATED this 21st day of August, 2012.

A handwritten signature in black ink, appearing to be "J. Reuben Clark", written over a horizontal line.

Certificate of Service

This is to certify that on the 21st day of August 2012, two true and correct copies of the Opening Brief of Appellants were served on the following via first class mail, postage prepaid:

Glenn C. Hanni
Stuart H. Schultz
STRONG & HANNI
3 Triad Center, Suite 500
Salt Lake City, UT 84180

A handwritten signature, likely of Stuart H. Schultz, is written over a horizontal line. The signature is stylized with a large 'S' and 'H'.

4826-5805-1343, v. 17

Tab A

FILED DISTRICT COURT
Third Judicial District

FEB 23 2012
SALT LAKE COUNTY
Deputy Clerk

Glenn C. Hanni (No. A1327)
Stuart H. Schultz (No. 2886)
Andrew D. Wright (No. 8857)
STRONG & HANNI
3 Triad Center, Suite 500
Salt Lake City, Utah 84180
Telephone: (801) 532-7080
Facsimile: (801) 596-1508
Attorneys for Defendants

IN THE THIRD JUDICIAL DISTRICT COURT

SALT LAKE COUNTY, STATE OF UTAH

HI-COUNTRY PROPERTY RIGHTS
GROUP, LINDSAY ATWOOD, JERRY
GILMORE, and BRANDON FRANK,
individually and for and on behalf of HI-
COUNTRY ESTATES HOMEOWNERS
ASSOCIATION, PHASE II, a Utah Non-profit
corporation,

Plaintiffs,

v.

KEITH EMMER, TOM WILLIAMS,
ANTHONY SARRA, ARLENE JOHNSON,
CAROL DEAN, HI-COUNTRY ESTATES
HOMEOWNERS ASSOCIATION, PHASE II,
a Utah non-profit corporation; and DOES 1-
100,

Defendants,

**ORDER OF DISMISSAL OF
PLAINTIFFS' SECOND CAUSE OF
ACTION, DERIVATIVE CLAIM FOR
BREACH OF FIDUCIARY DUTIES
AGAINST DEFENDANTS EMMER,
WILLIAMS, SARRA, JOHNSON AND
DEAN**

Civil No. 090920250

Judge Tyrone E. Medley

Defendants Renewed Motion to Dismiss and Motion for Partial Summary Judgment
as to Plaintiffs' Second Cause of Action for Breach of Fiduciary Duty was heard on January 18,

2012, before the Honorable Tyrone E. Medley, District Judge. Wade R. Budge and Michael J. Thomas of the Law Firm Snell & Wilmer appeared on behalf of plaintiffs. Stuart H. Schultz of the Law Firm Strong & Hanni and A. Howard Lundgren of the Law Firm Durham, Jones & Pinegar appeared on behalf of defendants. The Court, having reviewed the motions, the memoranda and papers filed in support of, and in opposition to, the motions, having heard oral argument from the parties, having taken the matter under advisement, and having rendered the Court's ruling during a telephone conference with counsel on January 30, 2012, and good cause appearing, now, therefore;

IT IS HEREBY ORDERED, ADJUDGED AND DECREED as follows:

1. Defendants' Renewed Motion to Dismiss Plaintiff's Second Cause of Action for Derivative Relief and Breach of Fiduciary Duties is granted for the reasons set forth more fully below, and, as a consequence of the Court granting the Renewed Motion to Dismiss, Defendants' Alternative Motion for Partial Summary Judgment on the Second Cause of Action for Breach of Fiduciary Duties, is rendered moot;

2. Defendants' Renewed Motion to Dismiss Plaintiffs' Second Cause of Action for Derivative Relief and for Breach of Fiduciary Duties against Defendants Emmer, Williams, Sarra, Johnson and Dean as members of the Board of Directors of Hi-Country Estates Homeowners Association, Phase II (hereinafter "HCEII") is granted and the Second Cause of Action against said defendants is dismissed, with prejudice, and on the merits, for the following reasons:

(a) All the necessary elements for dismissal of a derivative proceeding under Utah Code Ann. § 16-6a-612(4)(a) are met, including that a special litigation committee ("SLC") appointed by the Board of Directors of HCEII determined in good faith, after conducting a reasonable inquiry upon which the SLC's conclusions were based, that the maintenance of the derivative proceeding is not in the best interest of the non-profit corporation, HCEII;

(b) There are no genuine issues of material fact with respect to the independence of the members of the SLC, that the SLC made a determination in good faith, conducted a reasonable inquiry upon which its decision was based, and that there is a reasonable basis for the SLC's conclusion that the derivative proceeding is not in the best interest of HCEII;

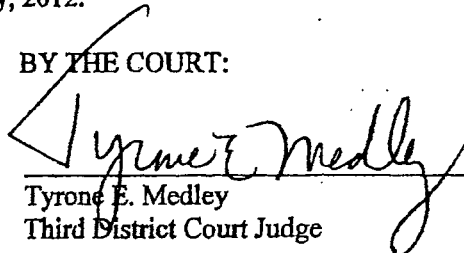
(c) Specifically with respect to the question of the independence of the members of the SLC, the Court finds first, based on the Kaplan v. White and London v. Tyrell cases that the alleged casual social relationship between Kim Wilson and the alleged business relationship between Sunrise Engineering and board members were limited in nature and did not create a genuine issue of material fact as to the independence of Mr. Wilson; second, that board membership alone is not a basis to find a lack of independence on the part of a member of the SLC; and third, that Utah Code Ann. § 16-6a-612(4)(c) states that being named as a director defendant does not create a lack of independence as a member of the SLC. Further, the Court concludes that the Beam case cited by plaintiffs supports granting the Motion to Dismiss, and that the Oracle case cited by Plaintiffs is inapposite because the facts are so extraordinarily different than the facts in the instant matter.

Based on the foregoing, and good cause appearing, now, therefore;

IT IS HEREBY ORDERED, ADJUDGED AND DECREED that Judgment of Dismissal is hereby entered with respect to Plaintiffs' Second Cause of Action—Derivative Claim for Breach of Fiduciary Duties against Williams, Emmer, Sarra, Johnson and Dean and said Second Cause of Action and all claims alleged therein is hereby dismissed, with prejudice, on the merits, no cause of action.

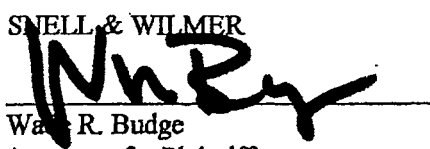
DATED this 22 day of February, 2012.

BY THE COURT:


Tyrone E. Medley
Third District Court Judge

Approved as to Form:

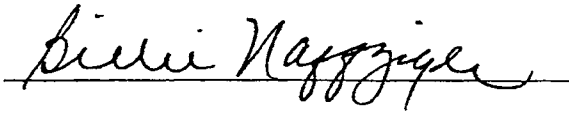
SNELL & WILMER


Wade R. Budge
Attorneys for Plaintiffs

CERTIFICATE OF SERVICE

I hereby certify that on this 15th day of February, 2012, a true and correct copy of the foregoing **Order of Dismissal of Plaintiffs' Second Cause of Action, Derivative Claim for Breach of Fiduciary Duties against Defendants Emmer, Williams, Sarra, Johnson and Dean** was served by the method indicated below to the following:

Wade R. Budge	<input checked="" type="checkbox"/> U.S. Mail, Postage Prepaid
Michael J. Thomas	<input type="checkbox"/> Hand Delivered
SNELL & WILMER	<input type="checkbox"/> Overnight Mail
15 West South Temple, Suite 1200	<input type="checkbox"/> Facsimile
Salt Lake City, UT 84101	
A. Howard Lundgren	<input checked="" type="checkbox"/> U.S. Mail, Postage Prepaid
DURHAM, JONES & PINEGAR	<input type="checkbox"/> Hand Delivered
111 E. Broadway, #900	<input type="checkbox"/> Overnight Mail
Salt Lake City, UT 84111	<input type="checkbox"/> Facsimile



001287.00384

Tab B

West's Utah Code Annotated

Title 16. Corporations

Chapter 6A. Utah Revised Nonprofit Corporation Act (Refs & Annos)

Part 6. Members

U.C.A. 1953 § 16-6a-612

§ 16-6a-612. Derivative suits

Currentness

(1) Without affecting the right of a member or director to bring a proceeding against a nonprofit corporation or its directors or officers, a proceeding may be brought in the right of a nonprofit corporation to procure a judgment in its favor by a complainant who is:

- (a) a voting member; or
- (b) a director in a nonprofit corporation that does not have voting members.

(2) A complainant may not commence or maintain a derivative proceeding unless the complainant:

- (a) is a voting member, or a director in a nonprofit corporation that does not have voting members, at the time the proceeding is brought; and
- (b) fairly and adequately represents the nonprofit corporation's interests in enforcing the nonprofit corporation's right.

(3)(a) A complainant may not commence a derivative proceeding until:

- (i) a written demand is made upon the nonprofit corporation to take suitable action; and
- (ii) 90 days have expired from the date the demand described in Subsection (3)(a)(i) is made, unless:
 - (A) the complainant is notified before the 90-day period expires that the demand is rejected by the nonprofit corporation; or
 - (B) irreparable injury to the nonprofit corporation would result by waiting for the 90-day period's expiration.

(b) A complaint in a derivative proceeding shall be:

- (i) verified; and
- (ii) allege with particularity the demand made to obtain action by the board of directors.

(c) A derivative proceeding shall comply with the procedures of Utah Rules of Civil Procedure, Rule 23.1.

(d) The court shall stay any derivative proceeding until the inquiry is completed and for an additional period as the court considers appropriate if:

- (i) the nonprofit corporation commences an inquiry into the allegations made in the demand or complaint; and
- (ii) a person or group described in Subsection (4) is conducting an active review of the allegations in good faith.

(e) If a nonprofit corporation proposes to dismiss a derivative proceeding pursuant to Subsection (4)(a), discovery by a complainant in the derivative proceeding:

(i) is limited to facts relating to:

(A) whether the person or group conducting the inquiry is independent and disinterested;

(B) the good faith of the inquiry; and

(C) the reasonableness of the procedures followed by the person or group conducting the inquiry; and

(ii) may not extend to any facts or substantive issues with respect to the act, omission, or other matter that is the subject matter of the derivative proceeding.

(4)(a) A derivative proceeding shall be dismissed by the court on motion by the corporation if a person or group specified in Subsection (4)(b) or (4)(f) determines in good faith, after conducting a reasonable inquiry upon which the person's or group's conclusions are based, that the maintenance of the derivative proceeding is not in the best interest of the nonprofit corporation.

(b) Unless a panel is appointed pursuant to Subsection (4)(f), the determination in Subsection (4)(a) shall be made by:

(i) a majority vote of independent directors present at a meeting of the board of directors, if the independent directors constitute a quorum; or

(ii) a majority vote of a committee consisting of two or more independent directors appointed by a majority vote of independent directors present at a meeting of the board of directors, whether or not the independent directors appointing the committee constituted a quorum.

(c) None of the following by itself causes a director to be considered not independent for purposes of this section:

(i) the nomination or election of the director by persons:

(A) who are defendants in the derivative proceeding; or

(B) against whom action is demanded;

(ii) the naming of the director as:

(A) a defendant in the derivative proceeding; or

(B) a person against whom action is demanded; or

(iii) the approval by the director of the act being challenged in the derivative proceeding or demand if the act resulted in no personal benefit to the director.

(d) If a derivative proceeding is commenced after a determination is made rejecting a demand by a complainant, the complaint shall allege with particularity facts establishing either:

(i) that a majority of the board of directors did not consist of independent directors at the time the determination was made; or

(ii) that the requirements of Subsection (4)(a) are not met.

(e)(i) If a majority of the board of directors does not consist of independent directors at the time the determination is made to reject a demand by a shareholder, the corporation has the burden of proving that the requirements of Subsection (4)(a) are met.

- (ii) If a majority of the board of directors consists of independent directors at the time the determination is made to reject a demand by a complainant, the plaintiff has the burden of proving that the requirements of Subsection (4)(a) are not met.
 - (f)(i) The court may appoint a panel of one or more independent persons upon motion by the corporation to make a determination whether the maintenance of the derivative proceeding is in the best interest of the corporation.
 - (ii) If the court appoints a panel under Subsection (4)(f)(i), the plaintiff has the burden of proving that the requirements of Subsection (4)(a) are not met.
 - (g) A person may appeal an interlocutory order of a court that grants or denies a motion to dismiss brought pursuant to Subsection (4)(a).
- (5) On termination of a derivative proceeding the court may order:
- (a) the nonprofit corporation to pay the plaintiff's reasonable expenses, including attorney fees, incurred in the proceeding, if it finds that the proceeding results in a substantial benefit to the nonprofit corporation;
 - (b) the plaintiff to pay a defendant's reasonable expenses, including attorney fees, incurred in defending the proceeding, if it finds that the proceeding was commenced or maintained:
 - (i) without reasonable cause; or
 - (ii) for an improper purpose; or
 - (c) a party to pay an opposing party's reasonable expenses, including attorney fees, incurred because of the filing of a pleading, motion, or other paper, if the court finds that the pleading, motion, or other paper was:
 - (i)(A) not well grounded in fact, after reasonable inquiry; or
 - (B) not warranted by existing law or a good faith argument for the extension, modification, or reversal of existing law; and
 - (ii) interposed for an improper purpose, such as to:
 - (A) harass;
 - (B) cause unnecessary delay; or
 - (C) cause needless increase in the cost of litigation.

Credits

Laws 2000, c. 300, § 56, eff. April 30, 2001; Laws 2006, c. 228, § 2, eff. May 1, 2006.

Notes of Decisions (4)

U.C.A. 1953 § 16-6a-612, UT ST § 16-6a-612

Current through 2012 General Session

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West's Utah Code Annotated

Title 16. Corporations

Chapter 6A. Utah Revised Nonprofit Corporation Act (Refs & Annos)

Part 8. Directors and Officers

U.C.A. 1953 § 16-6a-822

§ 16-6a-822. General standards of conduct for directors and officers

Currentness

(1)(a) A director shall discharge the director's duties as a director, including the director's duties as a member of a committee of the board, in accordance with Subsection (2).

(b) An officer with discretionary authority shall discharge the officer's duties under that authority in accordance with Subsection (2).

(2) A director or an officer described in Subsection (1) shall discharge the director or officer's duties:

(a) in good faith;

(b) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and

(c) in a manner the director or officer reasonably believes to be in the best interests of the nonprofit corporation.

(3) In discharging duties, a director or officer is entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, if prepared or presented by:

(a) one or more officers or employees of the nonprofit corporation whom the director or officer reasonably believes to be reliable and competent in the matters presented;

(b) legal counsel, a public accountant, or another person as to matters the director or officer reasonably believes are within the person's professional or expert competence;

(c) religious authorities or ministers, priests, rabbis, or other persons:

(i) whose position or duties in the nonprofit corporation, or in a religious organization with which the nonprofit corporation is affiliated, the director or officer believes justify reliance and confidence; and

(ii) who the director or officer believes to be reliable and competent in the matters presented; or

(d) in the case of a director, a committee of the board of directors of which the director is not a member if the director reasonably believes the committee merits confidence.

(4) A director or officer is not acting in good faith if the director or officer has knowledge concerning the matter in question that makes reliance otherwise permitted by Subsection (3) unwarranted.

(5) A director, regardless of title, may not be considered to be a trustee with respect to any property held or administered by the nonprofit corporation including property that may be subject to restrictions imposed by the donor or transferor of the property.

(6) A director or officer is not liable to the nonprofit corporation, its members, or any conservator or receiver, or any assignee or successor-in-interest of the nonprofit corporation or member, for any action taken, or any failure to take any action, as an officer or director, as the case may be, unless:

- (a) the director or officer has breached or failed to perform the duties of the office as set forth in this section; and
- (b) the breach or failure to perform constitutes:
 - (i) willful misconduct; or
 - (ii) intentional infliction of harm on:
 - (A) the nonprofit corporation; or
 - (B) the members of the nonprofit corporation; or
 - (iii) gross negligence.

Credits

Laws 2000, c. 300, § 97, eff. April 30, 2001; Laws 2006, c. 228, § 6, eff. May 1, 2006; Laws 2007, c. 306, § 12, eff. April 30, 2007.

Notes of Decisions (2)

U.C.A. 1953 § 16-6a-822, UT ST § 16-6a-822
Current through 2012 Fourth Special Session.

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West's Utah Code Annotated

Title 16. Corporations

Chapter 10A. Utah Revised Business Corporation Act

Part 7. Shareholders

U.C.A. 1953 § 16-10a-740

§ 16-10a-740. Procedure in derivative proceedings

Currentness

(1) As used in this section:

(a) "derivative proceeding" means a civil suit in the right of:

- (i) a domestic corporation; or
- (ii) to the extent provided in Subsection (7), a foreign corporation; and

(b) "shareholder" includes a beneficial owner whose shares are held:

- (i) in a voting trust; or
- (ii) by a nominee on the beneficial owner's behalf.

(2) A shareholder may not commence or maintain a derivative proceeding unless the shareholder:

(a)(i) was a shareholder of the corporation at the time of the act or omission complained of; or

(ii) became a shareholder through transfer by operation of law from one who was a shareholder at the time of the act or omission complained of; and

(b) fairly and adequately represents the interests of the corporation in enforcing the right of the corporation.

(3)(a) A shareholder may not commence a derivative proceeding until:

(i) a written demand has been made upon the corporation to take suitable action; and

(ii) 90 days have expired from the date the demand described in Subsection (3)(a)(i) is made unless:

- (A) the shareholder is notified before the 90 days have expired that the demand has been rejected by the corporation; or
- (B) irreparable injury to the corporation would result by waiting for the expiration of the 90-day period.

(b) A complaint in a derivative proceeding shall be:

- (i) verified; and
- (ii) allege with particularity the demand made to obtain action by the board of directors.

(c) A derivative proceeding shall comply with the procedures of Utah Rules of Civil Procedure, Rule 23A.

(d) The court shall stay any derivative proceeding until the inquiry is completed and for such additional period as the court considers appropriate if:

- (i) the corporation commences an inquiry into the allegations made in the demand or complaint; and
 - (ii) a person or group described in Subsection (4) is conducting an active review of the allegations in good faith.
- (e) If a corporation proposes to dismiss a derivative proceeding pursuant to Subsection (4)(a), discovery by a shareholder following the filing of the derivative proceeding in accordance with this section:
- (i) shall be limited to facts relating to:
 - (A) whether the person or group described in Subsection (4)(b) or (4)(f) is independent and disinterested;
 - (B) the good faith of the inquiry and review by the person or group described in Subsection (4)(b) or (4)(f); and
 - (C) the reasonableness of the procedures followed by the person or group described in Subsection (4)(b) or (4)(f) in conducting its review; and
 - (ii) may not extend to any facts or substantive matters with respect to the act, omission, or other matter that is the subject matter of the derivative proceeding.
- (4)(a) A derivative proceeding shall be dismissed by the court on motion by the corporation if a person or group specified in Subsections (4)(b) or (4)(f) determines in good faith after conducting a reasonable inquiry upon which its conclusions are based that the maintenance of the derivative proceeding is not in the best interests of the corporation.
- (b) Unless a panel is appointed pursuant to Subsection (4)(f), the determination in Subsection (4)(a) shall be made by:
- (i) a majority vote of independent directors present at a meeting of the board of directors if the independent directors constitute a quorum; or
 - (ii) a majority vote of a committee consisting of two or more independent directors appointed by a majority vote of independent directors present at a meeting of the board of directors, whether or not such independent directors appointing the committee constituted a quorum.
- (c) None of the following shall by itself cause a director to be considered not independent for purposes of this section:
- (i) the nomination or election of the director by persons:
 - (A) who are defendants in the derivative proceeding; or
 - (B) against whom action is demanded;
 - (ii) the naming of the director as:
 - (A) a defendant in the derivative proceeding; or
 - (B) a person against whom action is demanded; or
 - (iii) the approval by the director of the act being challenged in the derivative proceeding or demand if the act resulted in no personal benefit to the director.
- (d) If a derivative proceeding is commenced after a determination has been made rejecting a demand by a shareholder, the complaint shall allege with particularity facts establishing either:
- (i) that a majority of the board of directors did not consist of independent directors at the time the determination was made; or

(ii) that the requirements of Subsection (4)(a) have not been met.

(e)(i) If a majority of the board of directors does not consist of independent directors at the time the determination is made rejecting a demand by a shareholder, the corporation has the burden of proving that the requirements of Subsection (4)(a) have been met.

(ii) If a majority of the board of directors consists of independent directors at the time the determination is made rejecting a demand by a shareholder, the plaintiff has the burden of proving that the requirements of Subsection (4)(a) have not been met.

(f)(i) The court may appoint a panel of one or more independent persons upon motion by the corporation to make a determination whether the maintenance of the derivative proceeding is in the best interests of the corporation.

(ii) If the court appoints a panel under Subsection (4)(f)(i), the plaintiff has the burden of proving that the requirements of Subsection (4)(a) have not been met.

(g) A person may appeal from an interlocutory order of a court that grants or denies a motion to dismiss brought pursuant to Subsection (4)(a).

(5)(a) A derivative proceeding may not be discontinued or settled without the court's approval.

(b) If the court determines that a proposed discontinuance or settlement will substantially affect the interests of the corporation's shareholders or a class of shareholders, the court shall direct that notice be given to the shareholders affected.

(6) On termination of the derivative proceeding the court may order:

(a) the corporation to pay the plaintiff's reasonable expenses, including counsel fees, incurred in the proceeding, if it finds that the proceeding has resulted in a substantial benefit to the corporation;

(b) the plaintiff to pay any defendant's reasonable expenses, including counsel fees, incurred in defending the proceeding, if it finds that the proceeding was commenced or maintained:

(i) without reasonable cause; or

(ii) for an improper purpose; or

(c) a party to pay an opposing party's reasonable expenses, including counsel fees, incurred because of the filing of a pleading, motion, or other paper, if it finds that the pleading, motion, or other paper was:

(i)(A) not well grounded in fact, after reasonable inquiry; or

(B) not warranted by existing law or a good faith argument for the extension, modification, or reversal of existing law;
and

(ii) interposed for an improper purpose, such as to:

(A) harass;

(B) cause unnecessary delay; or

(C) cause needless increase in the cost of litigation.

(7)(a) In any derivative proceeding in the right of a foreign corporation, the matters covered by this section shall be governed by the laws of the jurisdiction of incorporation of the foreign corporation except for Subsections (3)(c), (3)(d), (5), and (6), which are procedural and not matters relating to the internal affairs of the foreign corporation.

(b) In the case of matters relating to a foreign corporation under Subsection (3)(c):

(i) references to a person or group described in Subsection (4) are considered to refer to a person or group entitled under the laws of the jurisdiction of incorporation of the foreign corporation to review and dispose of a derivative proceeding; and

(ii) the standard of review of a decision by the person or group to dismiss the derivative proceeding is to be governed by the laws of the jurisdiction of incorporation of the foreign corporation.

Credits

Laws 1992, c. 277, § 79; Laws 2000, c. 130, § 1, eff. May 1, 2000; Laws 2012, c. 369, § 2, eff. May 8, 2012.

Notes of Decisions (46)

U.C.A. 1953 § 16-10a-740, UT ST § 16-10a-740

Current through 2012 Fourth Special Session.

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Model Business Corporation Act Annotated

Fourth Edition

Model Business Corporation Act
with Official Comments and
Reporter's Annotations

adopted by the
Corporate Laws Committee
of the Business Law Section

Volume 1



identified as owner of the shares in the corporation's records, subject to certain provisos. If the corporation's record of shareholders has not been maintained in accordance with accepted practice, a person who would have been identified in the record if it had been so maintained is included. In addition to provisions similar to subdivisions (2), (3), and (4) of section 1.42, the California statute contains provisions relating to shares held subject to a voting trust or in a form used primarily to circumvent the provisions of the statute.

The remaining jurisdictions do not have comparable provisions in their general corporation acts. The close corporation statutes of many states contain analogous numerical limitations.

SELECTED CASES

No significant reported case for this section was found.

SELECTED REFERENCES

No significant reference for this section was found.

§ 1.43. QUALIFIED DIRECTOR

(a) A "qualified director" is a director who, at the time action is to be taken under:

- (1) section 7.44, does not have (i) a material interest in the outcome of the proceeding, or (ii) a material relationship with a person who has such an interest;
- (2) section 8.53 or 8.55, (i) is not a party to the proceeding, (ii) is not a director as to whom a transaction is a director's conflicting interest transaction or who sought a disclaimer of the corporation's interest in a business opportunity under section 8.70, which transaction or disclaimer is challenged in the proceeding, and (iii) does not have a material relationship with a director described in either clause (i) or clause (ii) of this subsection (a)(2);
- (3) section 8.62, is not a director (i) as to whom the transaction is a director's conflicting interest transaction, or (ii) who

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has a material relationship with another director as to whom the transaction is a director's conflicting interest transaction; or

- (4) section 8.70, would be a qualified director under subsection (a)(3) if the business opportunity were a director's conflicting interest transaction.

(b) For purposes of this section:

- (1) "material relationship" means a familial, financial, professional, employment or other relationship that would reasonably be expected to impair the objectivity of the director's judgment when participating in the action to be taken; and

- (2) "material interest" means an actual or potential benefit or detriment (other than one which would devolve on the corporation or the shareholders generally) that would reasonably be expected to impair the objectivity of the director's judgment when participating in the action to be taken.

(c) The presence of one or more of the following circumstances shall not automatically prevent a director from being a qualified director:

- (1) nomination or election of the director to the current board by any director who is not a qualified director with respect to the matter (or by any person that has a material relationship with that director), acting alone or participating with others;
- (2) service as a director of another corporation of which a director who is not a qualified director with respect to the matter (or any individual who has a material relationship with that director), is or was also a director; or
- (3) with respect to action to be taken under section 7.44, status as a named defendant, as a director against whom action is demanded, or as a director who approved the conduct being challenged.

CROSS-REFERENCES

Advance for expenses, see § 8.53.

Business opportunities, see § 8.70.

Determination and authorization for indemnification,
see § 8.55.

Directors' action in director's conflicting interest transaction,
see § 8.62.

Dismissal of derivative proceeding, see § 7.44.

OFFICIAL COMMENT

The definition of the term "qualified director" identifies those directors: (i) who may take action on the dismissal of a derivative proceeding (section 7.44); (ii) who are eligible to make, in the first instance, the authorization and determination required in connection with the decision on a request for advance for expenses (section 8.53(c)) or for indemnification (sections 8.55(b) and (c)); (iii) who may authorize a director's conflicting interest transaction (section 8.62); and (iv) who may disclaim the corporation's interest in a business opportunity (section 8.70(a)).

The judicial decisions that have examined the qualifications of directors for such purposes have generally required that directors be both *disinterested*, in the sense of not having exposure to an actual or potential benefit or detriment arising out of the action being taken (as opposed to an actual or potential benefit or detriment to the corporation or all shareholders generally), and *independent*, in the sense of having no personal or other relationship with an interested director (e.g., a director who is a party to a transaction with the corporation) that presents a reasonable likelihood that the director's objectivity will be impaired. The "qualified director" concept embraces both of those requirements, and its application is situation-specific; that is, "qualified director" determinations will depend upon the directly relevant facts and circumstances, and the disqualification of a director to act arises from factors that would reasonably be expected to impair the objectivity of the director's judgment. On the other hand, the concept does not suggest that a "qualified

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director” has or should have special expertise to act on the matter in question.

1. Disqualification Due to Conflicting Interest

The “qualified director” concept prescribes significant disqualifications, depending upon the purpose for which a director might be considered eligible to participate in the action to be taken. In each context in which the definition applies, it excludes directors who should not be considered disinterested:

- In the case of action on dismissal of a derivative proceeding under section 7.44, the definition excludes directors who have a material interest in the outcome of the proceeding, such as where the proceeding involves a challenge to the validity of a transaction in which the director has a material financial interest. As defined in subsection (b)(2), a “material interest” in the outcome of the proceeding involves an actual or potential benefit (other than one that would devolve on the corporation or the shareholders generally) that would arise from dismissal of the proceeding and would reasonably be expected to impair the objectivity of the director’s judgment in acting on dismissal of the proceeding.
- In the case of action to approve indemnification or advance of funds for expenses, the definition excludes directors who are parties to the proceeding (see section 8.50(6) for the definition of “party” and section 8.50(7) for the definition of “proceeding”). It also excludes a director who is not a party to the proceeding but as to whom a transaction is a director’s conflicting interest transaction or who sought a disclaimer of the corporation’s interest in a business opportunity, where that transaction or disclaimer is challenged in the proceeding.
- In the case of action to approve a director’s conflicting interest transaction, the definition excludes any director whose interest, knowledge or status results in the transaction being treated as a “director’s conflicting

interest transaction.” See section 8.60(1) for the definition of “director’s conflicting interest transaction.”

- Finally, in the case of action under section 8.70(a) to disclaim corporate interest in a business opportunity, the definition excludes any director who would not be considered a “qualified director” if the business opportunity were a “director’s conflicting interest transaction.”

Whether a director has a material interest in the outcome of a proceeding in which the director does not have a conflicting personal interest is heavily fact-dependent. Such cases lie along a spectrum. At one end of the spectrum, if a claim against a director is clearly frivolous or is not supported by particularized and well-pleaded facts, the director should not be deemed to have a “material interest in the outcome of the proceeding” within the meaning of subsection (a)(1), even though the director is named as a defendant. At the other end of the spectrum, a director normally should be deemed to have a “material interest in the outcome of the proceeding” within the meaning of subsection (a)(1) if a claim against the director is supported by particularized and well-pleaded facts which, if true, would be likely to give rise to a significant adverse outcome against the director. Whether a director should be deemed to have a “material interest in the outcome of the proceeding” based on a claim that lies between these two ends of the spectrum will depend on the application of that test to the claim, given all the facts and circumstances.

2. Disqualification Due to Relationships with Interested Persons

In each context in which the “qualified director” definition applies, it also excludes a director who has a “material relationship” with another director who is not disinterested for one or more of the reasons outlined in the preceding paragraph. Any relationship with such a director, whether the relationship is familial, financial, professional, employment or otherwise, is a “material relationship,” as that term is defined in subsection (b)(1), where it would reasonably be expected to impair the objectivity of the director’s judgment when voting or otherwise participating in action to be

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taken on a matter referred to in subsection (a). The determination of whether there is a “material relationship” should be based on the practicalities of the situation rather than on formalistic considerations. For example, a director employed by a corporation controlled by another director should be regarded as having an employment relationship with that director. On the other hand, a casual social acquaintance with another director should not be regarded as a disqualifying relationship. See *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 845 A.2d 1040, 1050 (Del. 2004).

Although the term “qualified director” embraces the concept of independence, it does so only in relation to the director’s interest or involvement in the specific situations to which the definition applies. Thus, the term “qualified director” is distinct from the generic term “independent director” used in section 8.01(c) of the Act to describe a director’s general status. As a result, an “independent director” may in some circumstances not be a “qualified director,” and vice versa. For example, in action being taken under section 8.70 concerning a business opportunity, an “independent” director who has a material interest in the business opportunity would not be a “qualified director” eligible to vote on the matter. Conversely, a director who does not have “independent” status may be a “qualified director” for purposes of voting on that action. See also the Official Comment to section 8.01(c).

3. *Elimination of Automatic Disqualification in Certain Circumstances*

- Subsection (c) of the definition of “qualified director” addresses three categories of circumstances that, if present alone or together, do not automatically prevent a director from being a qualified director.
- Subsection (c)(1) makes it clear that the participation of nonqualified directors (or interested shareholders or other interested persons) in the nomination or election of a director does not automatically prevent the director so nominated or elected from being qualified. Special

litigation committees acting upon the dismissal of derivative litigation often consist of directors elected (after the alleged wrongful acts) by directors named as defendants in the action. In other settings, directors who are seeking indemnification, or who are interested in a director's conflicting interest transaction, may have participated in the nomination or election of an individual director who is otherwise a "qualified director."

- Subsection (c)(2) provides, in a similar fashion, that the mere fact that an individual director is or was a director of another corporation—on the board of which a director who is not a "qualified director" also serves or has served—does not automatically prevent qualification to act.
- Subsection (c)(3) confirms a number of decisions, involving dismissal of derivative proceedings, in which the court rejected a disqualification claim predicated on the mere fact that a director had been named as a defendant, was an individual against whom action has been demanded, or had approved the action being challenged. These cases have held that, where a director's approval of the challenged action is at issue, approval does not automatically make the director ineligible to act. See *Aronson v. Lewis*, 473 A.2d 805, 816 (Del. 1984); *Lewis v. Graves*, 701 F.2d 245 (2d Cir.1983). On the other hand, for example, director approval of a challenged transaction, in combination with other particularized facts showing that the director's ability to act objectively on a proposal to dismiss a derivative proceeding is impaired by a material conflicting personal interest in the transaction, disqualifies a director from acting on the proposal to dismiss the proceeding.

Where status as a qualified director is challenged in a litigation context, the court must assess the likelihood that an interest or relationship has impaired a director's objectivity, without the need for any presumption arising from the presence of one or more of the three specified circumstances. Thus, the effect of subsection (c) of the definition, while significant, is limited. It

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merely precludes an automatic inference of director disqualification from the circumstances specified in clauses (1), (2) and (3) of subsection (c).

ANNOTATION

HISTORY

Model Act Derivation

1984 Act § 1.43 added by amendment, proposed
60 BUS. LAW, 341 (2004), adopted, 60 BUS.
LAW, 943 (2005)

Historical Background

Section 1.43 is a refined and expanded version of the term “qualified director” as first used in section 8.62 to describe the characteristics of directors eligible to approve a director’s conflicting interest transaction. The definition continues to be applicable to director action approving a director’s conflicting interest under section 8.62 but now also applies to director action with respect to derivative suits (section 7.44), indemnification (sections 8.53 and 8.55), and disavowal of the corporation’s interest in a business opportunity (section 8.70). The term “qualified director” is different than the concept of “independent director” that is referred to in section 8.01 and the Official Comment to section 8.25. The term “independent director” is not defined in the Act, but is variously defined in the listing standards for several securities market. As used in such standards, “independent director” is largely defined in terms of the absence of relationships (other than serving as a director) between the corporation and the director. Accordingly, “independent director” does not relate to the director’s disinterestedness with respect to a particular matter, and it is the latter concept with which section 1.43 is concerned.

STATUTES

Conn. Gen. Stat. Ann. § 33-605 (West)

Me. Rev. Stat. tit. 13C, § 102 (32A)

Miss. Code Ann. § 79-4-1.43

Wyo. Stat. § 17-16-143

STATUTORY COMPARISON

Connecticut, Maine, Mississippi, and Wyoming have adopted section 1.43, thereby applying the uniform "qualified director" definition to board action concerning dismissal of derivative suits, permissive indemnification and advance of expenses, and director conflicting interest transactions. For statutes applying a similar concept in those circumstances, see the Annotations to sections 7.44, 8.53, 8.55, and 8.62.

SELECTED CASES AND REFERENCES

See the Annotations to section 8.62; see also Annotations to sections 7.44, 8.53 and 8.55.

§ 1.44. HOUSEHOLDING

- (a) A corporation has delivered written notice or any other report or statement under this Act, the articles of incorporation or the bylaws to all shareholders who share a common address if:
- (1) The corporation delivers one copy of the notice, report or statement to the common address;
 - (2) The corporation addresses the notice, report or statement to those shareholders either as a group or to each of those shareholders individually or to the shareholders in a form to which each of those shareholders has consented; and
 - (3) Each of those shareholders consents to delivery of a single copy of such notice, report or statement to the shareholders' common address.

Any such consent shall be revocable by any of such shareholders who deliver written notice of revocation

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Reporter's Annotations

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STATUTORY COMPARISON

Each of the jurisdictions listed above has adopted section 7.43 with little substantive change. Texas, however, requires the corporation to notify the court and plaintiff upon completion of review; the initial stay of 60 days may be renewed for one or more additional 60-day periods if the corporation files a written statement describing the status of the review and the reasons why additional time is needed. The Texas statute also describes the effect of filing demand on the applicable statute of limitations.

For comparison to other state statutes, see the Annotation to section 7.40.

§ 7.44. DISMISSAL

- (a) A derivative proceeding shall be dismissed by the court on motion by the corporation if one of the groups specified in subsection (b) or subsection (e) has determined in good faith, after conducting a reasonable inquiry upon which its conclusions are based, that the maintenance of the derivative proceeding is not in the best interests of the corporation.
- (b) Unless a panel is appointed pursuant to subsection (e), the determination in subsection (a) shall be made by:
 - (1) a majority vote of qualified directors present at a meeting of the board of directors if the qualified directors constitute a quorum; or
 - (2) a majority vote of a committee consisting of two or more qualified directors appointed by majority vote of qualified directors present at a meeting of the board of directors, regardless of whether such qualified directors constitute a quorum.
- (c) If a derivative proceeding is commenced after a determination has been made rejecting a demand by a shareholder, the complaint shall allege with particularity facts establishing either (1) that a majority of the board of directors did not consist of qualified directors at the time the determination was made or (2) that the requirements of subsection (a) have not been met.

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- (d) If a majority of the board of directors consisted of qualified directors at the time the determination was made, the plaintiff shall have the burden of proving that the requirements of subsection (a) have not been met; if not, the corporation shall have the burden of proving that the requirements of subsection (a) have been met.
- (e) Upon motion by the corporation, the court may appoint a panel of one or more individuals to make a determination whether the maintenance of the derivative proceeding is in the best interests of the corporation. In such case, the plaintiff shall have the burden of proving that the requirements of subsection (a) have not been met.

CROSS-REFERENCES

Board of directors:

committees, see § 8.25.

meetings, see § 8.20.

quorum and voting, see § 8.24.

Demand, see § 7.41.

"Derivative proceeding" defined, see § 7.40.

"Qualified director" defined, see § 1.43.

"Shareholder" defined, see § 7.40.

OFFICIAL COMMENT

At one time, the Model Act did not expressly provide what happens when a board of directors properly rejects a demand to bring an action. In such event, judicial decisions indicate that the rejection should be honored and any ensuing derivative action should be dismissed. See *Aronson v. Lewis*, 473 A.2d 805, 813 (Del. 1984). The Model Act was also silent on the effect of a determination by a special litigation committee of qualified directors that a previously commenced derivative action should be dismissed. Section 7.44(a) specifically provides that the proceeding shall be dismissed if there is a proper determination that the maintenance of the proceeding is not in the best interests of the corporation.

That determination can be made prior to commencement of the derivative action in response to a demand or after commencement of the action upon examination of the allegations of the complaint.

The procedures set forth in section 7.44 are not intended to be exclusive. As noted in the comment to section 7.42, there may be instances where a decision to commence an action falls within the authority of an officer of the corporation, depending upon the amount of the claim and the identity of the potential defendants.

1. *The Persons Making the Determination*

Section 7.44(b) prescribes the persons by whom the determination in subsection (a) may be made. Subsection (b) provides that the determination may be made (1) at a board meeting by a majority vote of qualified directors if the qualified directors constitute a quorum, or (2) by a majority vote of a committee consisting of two or more qualified directors appointed at a board meeting by a vote of the qualified directors in attendance, regardless of whether they constitute a quorum. (For the definition of "qualified director," see section 1.43 and the related official comment.) These provisions parallel the mechanics for determining entitlement to indemnification (section 8.55), for authorizing directors' conflicting interest transactions (section 8.62), and for renunciation of the corporation's interests in a business opportunity (section 8.70). Subsection (b)(2) is an exception to section 8.25 of the Model Act, which requires the approval of at least a majority of all the directors in office to create a committee and appoint members. This approach has been taken to respond to the criticism expressed in a few cases that special litigation committees suffer from a structural bias because of their appointment by vote of directors who at that time are not qualified directors. See *Hasan v. Trust Realty Investors*, 729 F.2d 372, 376-77 (6th Cir. 1984).

Subsection (e) provides, as an alternative, for a determination by a panel of one or more individuals appointed by the court. The subsection provides for the appointment only upon motion by

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the corporation. This would not, however, prevent the court on its own initiative from appointing a special master pursuant to applicable state rules of procedure. (Although subsection (b)(2) requires a committee of at least two qualified directors, subsection (e) permits the appointment by the court of only one person in recognition of the potentially increased costs to the corporation for the fees and expenses of an outside person.)

This panel procedure may be desirable in a number of circumstances. If there are no qualified directors available, the corporation may not wish to enlarge the board to add qualified directors or may be unable to find persons willing to serve as qualified directors. In addition, even if there are directors who are qualified, they may not be in a position to conduct the inquiry in an expeditious manner.

Appointment by the court should also eliminate any question about the qualifications of the individual or individuals constituting the panel making the determination. Although the corporation may wish to suggest to the court possible appointees, the court will not be bound by those suggestions and, in any case, will want to satisfy itself with respect to each candidate's impartiality. When the court appoints a panel, subsection (e) places the burden on the plaintiff to prove that the requirements of subsection (a) have not been met.

2. *Standards to Be Applied*

Section 7.44(a) requires that the determination, by the appropriate person or persons, be made "in good faith, after conducting a reasonable inquiry upon which their conclusions are based." The phrase "in good faith" modifies both the determination and the inquiry. This standard, which is also found in sections 8.30 (general standards of conduct for directors) and 8.51 (authority to indemnify) of the Model Act, is a subjective one, meaning "honestly or in an honest manner." See also *Corporate Director's Guidebook* (Fifth Edition), 59 BUS. LAW. 1057, 1068 (2007). As stated in *Abella v. Universal Leaf Tobacco Co.*, 546 F. Supp. 795, 300 (E.D. Va. 1982), "the inquiry intended by this phrase goes to the spirit and sincerity with which the investigation was

conducted, rather than the reasonableness of its procedures or basis for conclusions.”

The word “inquiry”—rather than “investigation”—has been used to make it clear that the scope of the inquiry will depend upon the issues raised and the knowledge of the group making the determination with respect to those issues. In some cases, the issues may be so simple or the knowledge of the group so extensive that little additional inquiry is required. In other cases, the group may need to engage counsel and possibly other professionals to make an investigation and assist the group in its evaluation of the issues.

The phrase “upon which its conclusions are based” requires that the inquiry and the conclusions follow logically. This standard authorizes the court to examine the determination to ensure that it has some support in the findings of the inquiry. The burden of convincing the court about this issue lies with whichever party has the burden under subsection (d). This phrase does not require the persons making the determination to prepare a written report that sets forth their determination and the bases therefor, since circumstances will vary as to the need for such a report. There will be, in all likelihood, many instances where good corporate practice will commend such a procedure.

Section 7.44 is not intended to modify the general standards of conduct for directors set forth in section 8.30 of the Model Act, but rather to make those standards somewhat more explicit in the derivative proceeding context. In this regard, the qualified directors making the determination would be entitled to rely on information and reports from other persons in accordance with section 8.30(d).

Section 7.44 is similar in several respects and differs in certain other respects from the law as it has developed in Delaware and been followed in a number of other states. Under the Delaware cases, the role of the court in reviewing the directors’ determination varies depending upon whether the plaintiff is in a demand-required or demand-excused situation.

Since section 7.42 requires demand in all cases, the distinction between demand-excused and demand-required cases

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does not apply. Subsections (c) and (d) carry forward that distinction, however, by establishing pleading rules and allocating the burden of proof depending on whether there is a majority of qualified directors on the board. Subsection (c), like Delaware law, assigns to the plaintiff the threshold burden of alleging facts establishing that the majority of the directors on the board are not qualified. If there is a majority, then the burden remains with the plaintiff to plead and establish that the requirements of subsection (a) section 7.44(a) have not been met. If there is not a majority of qualified directors on the board, then the burden is on the corporation to prove that the issues delineated in subsection (a) have been satisfied; that is, the corporation must prove both the eligibility of the decision makers to act on the matter and the propriety of their inquiry and determination.

Thus, the burden of proving that the requirements of subsection (a) have not been met will remain with the plaintiff in several situations. First, where the determination to dismiss the derivative proceeding is made in accordance with subsection (b)(1), the burden of proof will generally remain with the plaintiff since the subsection requires a quorum of qualified directors and a quorum is normally a majority. See section 8.24. The burden will also remain with the plaintiff if a majority of qualified directors has appointed a committee under subsection (b)(2), and the qualified directors constitute a majority of the board. Under subsection (e), the burden of proof also remains with the plaintiff in the case of a determination by a panel appointed by the court.

The burden of proof will shift to the corporation, however, where a majority of the board members are not qualified and the determination is made by a committee under subsection (b)(2). It can be argued that, if the directors making the determination under subsection (b)(2) are qualified and have been delegated full responsibility for making the decision, the composition of the entire board is irrelevant. This argument is buttressed by the section's method of appointing the group specified in subsection (b)(2), since it departs from the general method of appointing committees and allows only qualified directors, rather than a majority of the entire board, to appoint the committee that will

make the determination. Subsection (d)'s response to objections suggesting structural bias is to place the burden of proof on the corporation (despite the fact that the committee making the determination is composed exclusively of qualified directors).

Finally, section 7.44 does not authorize the court to review the reasonableness of the determination to reject a demand or seek dismissal. This contrasts with the approach in some states that permits a court, at least in some circumstances, to review the merits of the determination (*see Zapata Corp. v. Maldonado*, 430 A.2d 779, 789 (Del. 1981)) and is similar to the approach taken in other states (*see Auerbach v. Bennett*, 393 N.E.2d 994, 1002-03 (N.Y. 1979)).

3. Pleading

The Model Act previously provided that the complaint in a derivative proceeding must allege with particularity either that demand had been made on the board of directors, together with the board's response, or why demand was excused. This requirement is similar to rule 23.1 of the Federal Rules of Civil Procedure. Since demand is now required in all cases, this provision is no longer necessary.

Subsection (c) sets forth a modified pleading rule to cover the typical situation where the plaintiff makes demand on the board, the board rejects that demand, and the plaintiff commences an action. In that scenario, in order to state a cause of action, subsection (c) requires the complaint to allege with particularity facts demonstrating either (1) that no majority of qualified directors exists or (2) why the determination made by qualified directors does not meet the standards in subsection (a). Discovery should be available to the plaintiff only after the plaintiff has successfully stated a cause of action by making either of these two showings.

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ANNOTATION

HISTORY

Model Act Derivation

1984 Act § 7.44 amended, proposed 60 BUS. LAW. 341
(2005), adopted 60 BUS. LAW. 943 (2005)

See also the Annotation to section 7.40.

STATUTES

Ariz. Rev. Stat. Ann. § 10-744
Conn. Gen. Stat. Ann. § 33-724 (West)
Fla. Stat. Ann. § 607.07401(3)
Ga. Code Ann. § 14-2-744
Haw. Rev. Stat. § 414-175
Idaho Code § 30-1-744
Iowa Code Ann. § 490.744 (West)
Me. Rev. Stat. Ann. tit. 13-C, § 755
Mass. Gen. Laws Ann. ch. 156D, § 7.44 (West)
Mich. Comp. Laws Ann. §§ 450.1491a, 450.1495 (West)
Miss. Code Ann. § 79-4-7.44
Mont. Code Ann. § 35-1-545
Neb. Rev. Stat. § 21-2074
N.H. Rev. Stat. Ann. § 293-A:7.44
N.C. Gen. Stat. § 55-7-44
R.I. Gen. Laws § 7-1.2-710(E)
S.D. Codified Laws §§ 47-1A-744-47-1A-744.5
Tex. Bus. Org. Code Ann. § 21.558 (Vernon)
Va. Code Ann. § 13.1-672.4
Wis. Stat. Ann. § 180.0744 (West)
Wyo. Stat. § 17-16-744

For a list of other statutes dealing with derivative proceedings,
see the Annotation to section 7.40.



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Model Business Corporation Act

Official Text
with Official Comment and
Statutory Cross-References
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the circumstances, which would include oral notice through voice mail or other similar means. It also deals with situations where notice may be sought to be given to persons for whom no current address is available, or where personal notice is impractical. Notice delivered to the person's last known address is effective as described in section 1.41(e) even though never actually received by the person. Section 1.41(b) also authorizes notice by publication in some circumstances, including radio, television, or other form of public wire or wireless communication.

Section 1.41(g) recognizes that other sections of the Act prescribe specific notice requirements for particular situations—e.g., service of process on a corporation's registered agent under section 5.04—and that these specific requirements, rather than the general requirements of section 1.41, control. Finally, the second sentence of subsection 1.41(g) permits a corporation's articles of incorporation or bylaws to prescribe the corporation's own notice requirements, if they are not inconsistent with the general requirements of this section or specific requirements of other sections of the Act.

The rules set forth in section 1.41 permit many other sections of the Model Act to be phrased simply in terms of giving or delivering notice without repeating details with respect to how notice should be given and when it is effective in various circumstances.

§ 1.42. NUMBER OF SHAREHOLDERS

- (a) For purposes of this Act, the following identified as a shareholder in a corporation's current record of shareholders constitutes one shareholder:
 - (1) three or fewer co-owners;
 - (2) a corporation, partnership, trust, estate, or other entity;
 - (3) the trustees, guardians, custodians, or other fiduciaries of a single trust, estate, or account.
- (b) For purposes of this Act, shareholdings registered in substantially similar names constitute one shareholder if it is

reasonable to believe that the names represent the same person.

CROSS-REFERENCES

Board of directors, see § 8.01.

Close corporations, see Model **Statutory Close Corporation Supplement**.

"Entity" defined, see § 1.40.

Record of shareholders, see §§ 7.20 & 16.01.

"Shareholder" defined, see § 1.40.

Voting trusts, see § 7.30.

OFFICIAL COMMENT

Section 1.42 provides rules for determining the number of shareholders in a corporation. The Model Act generally avoids provisions that are based on the number of shareholders of a corporation, since these provisions may encourage individual shareholders to divide or combine their holdings for private strategic advantage. But in one instance the number of shareholders is important: to permit a corporation to elect close corporation status under the Model Statutory Close Corporation Supplement. The determination of the precise number of shareholders may also become important in other contexts in the future.

§ 1.43. QUALIFIED DIRECTOR

- (a) A "qualified director" is a director who, at the time action is to be taken under:
 - (1) section 7.44, does not have (i) a material interest in the outcome of the proceeding, or (ii) a material relationship with a person who has such an interest;
 - (2) section 8.53 or 8.55, (i) is not a party to the proceeding, (ii) is not a director as to whom a transaction is a di-

director's conflicting interest transaction or who sought a disclaimer of the corporation's interest in a business opportunity under section 8.70, which transaction or disclaimer is challenged in the proceeding, and (iii) does not have a material relationship with a director described in either clause (i) or clause (ii) of this subsection (a)(2);

- (3) section 8.62, is not a director (i) as to whom the transaction is a director's conflicting interest transaction, or (ii) who has a material relationship with another director as to whom the transaction is a director's conflicting interest transaction; or
 - (4) section 8.70, would be a qualified director under subsection (a)(3) if the business opportunity were a director's conflicting interest transaction.
- (b) For purposes of this section,
- (1) "material relationship" means a familial, financial, professional, employment or other relationship that would reasonably be expected to impair the objectivity of the director's judgment when participating in the action to be taken; and
 - (2) "material interest" means an actual or potential benefit or detriment (other than one which would devolve on the corporation or the shareholders generally) that would reasonably be expected to impair the objectivity of the director's judgment when participating in the action to be taken.
- (c) The presence of one or more of the following circumstances shall not automatically prevent a director from being a qualified director:
- (1) nomination or election of the director to the current board by any director who is not a qualified director with respect to the matter (or by any person that has a material relationship with that director), acting alone or participating with others;
 - (2) service as a director of another corporation of which a director who is not a qualified director with respect to

the matter (or any individual who has a material relationship with that director), is or was also a director; or

- (3) with respect to action to be taken under section 7.44, status as a named defendant, as a director against whom action is demanded, or as a director who approved the conduct being challenged.

CROSS-REFERENCES

Advance for expenses, see § 8.53

Determination and authorization for indemnification, see § 8.55

Directors' action in director's conflicting interest transaction, see § 8.62

Dismissal of derivative proceeding, see § 7.44

OFFICIAL COMMENT

The definition of the term "qualified director" identifies those directors: (i) who may take action on the dismissal of a derivative proceeding (section 7.44); (ii) who are eligible to make, in the first instance, the authorization and determination required in connection with the decision on a request for advance for expenses (section 8.53(c)) or for indemnification (sections 8.55(b) and (c)); (iii) who may authorize a director's conflicting interest transaction (section 8.62); and (iv) who may disclaim the corporation's interest in a business opportunity (section 8.70(a)).

The judicial decisions that have examined the qualifications of directors for such purposes have generally required that directors be both *disinterested*, in the sense of not having exposure to an actual or potential benefit or detriment arising out of the action being taken (as opposed to an actual or potential benefit or detriment to the corporation or all shareholders generally), and *independent*, in the sense of having no personal or other relationship with an interested director (*e.g.*, a director who is a party to a transaction with the corporation) that presents a reasonable likelihood that the director's objectivity will be impaired. The "qualified director" concept embraces both of those requirements, and

its application is situation-specific; that is, "qualified director" determinations will depend upon the directly relevant facts and circumstances, and the disqualification of a director to act arises from factors that would reasonably be expected to impair the objectivity of the director's judgment. On the other hand, the concept does not suggest that a "qualified director" has or should have special expertise to act on the matter in question.

1. DISQUALIFICATION DUE TO CONFLICTING INTEREST

The "qualified director" concept prescribes significant disqualifications, depending upon the purpose for which a director might be considered eligible to participate in the action to be taken. In each context in which the definition applies, it excludes directors who should not be considered disinterested:

- In the case of action on dismissal of a derivative proceeding under section 7.44, the definition excludes directors who have a material interest in the outcome of the proceeding, such as where the proceeding involves a challenge to the validity of a transaction in which the director has a material financial interest. As defined in subsection (b)(2), a "material interest" in the outcome of the proceeding involves an actual or potential benefit (other than one that would devolve on the corporation or the shareholders generally) that would arise from dismissal of the proceeding and would reasonably be expected to impair the objectivity of the director's judgment in acting on dismissal of the proceeding.
- In the case of action to approve indemnification or advance of funds for expenses, the definition excludes directors who are parties to the proceeding (see section 8.50(6) for the definition of "party" and section 8.50(7) for the definition of "proceeding"). It also excludes a director who is not a party to the proceeding but as to whom a transaction is a director's conflicting interest transaction or who sought a disclaimer of the corporation's interest in a business opportunity, where that transaction or disclaimer is challenged in the proceeding.
- In the case of action to approve a director's conflicting interest transaction, the definition excludes any director

whose interest, knowledge or status results in the transaction being treated as a "director's conflicting interest transaction." See section 8.60(1) for the definition of "director's conflicting interest transaction."

- Finally, in the case of action under section 8.70(a) to disclaim corporate interest in a business opportunity, the definition excludes any director who would not be considered a "qualified director" if the business opportunity were a "director's conflicting interest transaction."

Whether a director has a material interest in the outcome of a proceeding in which the director does not have a conflicting personal interest is heavily fact-dependent. Such cases lie along a spectrum. At one end of the spectrum, if a claim against a director is clearly frivolous or is not supported by particularized and well-pleaded facts, the director should not be deemed to have a "material interest in the outcome of the proceeding" within the meaning of subsection (a)(1), even though the director is named as a defendant. At the other end of the spectrum, a director normally should be deemed to have a "material interest in the outcome of the proceeding" within the meaning of subsection (a)(1) if a claim against the director is supported by particularized and well-pleaded facts which, if true, would be likely to give rise to a significant adverse outcome against the director. Whether a director should be deemed to have a "material interest in the outcome of the proceeding" based on a claim that lies between these two ends of the spectrum will depend on the application of that test to the claim, given all the facts and circumstances.

2. DISQUALIFICATION DUE TO RELATIONSHIPS WITH INTERESTED PERSONS

In each context in which the "qualified director" definition applies, it also excludes a director who has a "material relationship" with another director who is not disinterested for one or more of the reasons outlined in the preceding paragraph. Any relationship with such a director, whether the relationship is familial, financial, professional, employment or otherwise, is a "material relationship," as that term is defined in subsection (b)(1), where it would reasonably be expected to impair the objectivity of the director's judgment when voting or otherwise par-

icipating in action to be taken on a matter referred to in subsection (a). The determination of whether there is a "material relationship" should be based on the practicalities of the situation rather than on formalistic considerations. For example, a director employed by a corporation controlled by a director should be regarded as having an employment relationship with that director. On the other hand, a casual social acquaintance with another director should not be regarded as a disqualifying relationship. See *Team ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 45 A.2d 1040, 1050 (Del. 2004).

Although the term "qualified director" embraces the concept of independence, it does so only in relation to the director's interest or involvement in the specific situations to which the definition applies. Thus, the term "qualified director" is distinct from the generic term "independent director" used in section 3.01(c) of the Act to describe a director's general status. As a result, an "independent director" may in some circumstances not be a "qualified director," and vice versa. For example, in action being taken under section 8.70 concerning a business opportunity, an "independent" director who has a material interest in the business opportunity would not be a "qualified director" eligible to vote on the matter. Conversely, a director who does not have independent status may be a "qualified director" for purposes of voting on that action. See also the Official Comment to section 3.01(c).

ELIMINATION OF AUTOMATIC DISQUALIFICATION IN CERTAIN CIRCUMSTANCES

- Subsection (c) of the definition of "qualified director" addresses three categories of circumstances that, if present alone or together, do not automatically prevent a director from being a qualified director.
- Subsection (c)(1) makes it clear that the participation of non-qualified directors (or interested shareholders or other interested persons) in the nomination or election of a director does not automatically prevent the director so nominated or elected from being qualified. Special litigation committees acting upon the dismissal of derivative litigation often consist of directors elected (after the alleged

wrongful acts) by directors named as defendants in the action. In other settings, directors who are seeking indemnification, or who are interested in a director's conflicting interest transaction, may have participated in the nomination or election of an individual director who is otherwise a "qualified director."

- Subsection (c)(2) provides, in a similar fashion, that the mere fact that an individual director is or was a director of another corporation—on the board of which a director who is not a "qualified director" also serves or has served—does not automatically prevent qualification to act.
- Subsection (c)(3) confirms a number of decisions, involving dismissal of derivative proceedings, in which the court rejected a disqualification claim predicated on the mere fact that a director had been named as a defendant, was an individual against whom action has been demanded, or had approved the action being challenged. These cases have held that, where a director's approval of the challenged action is at issue, approval does not automatically make the director ineligible to act. See *Aronson v. Lewis*, 473 A. 2d 805, 816 (Del. 1984); *Lewis v. Graves*, 701 F.2d 245 (2d Cir.1983). On the other hand, for example, director approval of a challenged transaction, in combination with other particularized facts showing that the director's ability to act objectively on a proposal to dismiss a derivative proceeding is impaired by a material conflicting personal interest in the transaction, disqualifies a director from acting on the proposal to dismiss the proceeding.

Where status as a qualified director is challenged in a litigation context, the court must assess the likelihood that an interest or relationship has impaired a director's objectivity, without the need for any presumption arising from the presence of one or more of the three specified circumstances. Thus, the effect of subsection (c) of the definition, while significant, is limited. It merely precludes an automatic inference of director disqualification from the circumstances specified in clauses (1), (2) and (3) of subsection (c).

inquiry is completed or, if suit is commenced, the corporation can apply to the court for a stay under section 7.43.

Two exceptions are provided to the 90-day waiting period. The first exception is the situation where the shareholder has been notified of the rejection of the demand prior to the end of the 90 days. The second exception is where irreparable injury to the corporation would otherwise result if the commencement of the proceeding is delayed for the 90-day period. The standard to be applied is intended to be the same as that governing the entry of a preliminary injunction. Compare *Gimbel v. Signal Cos.*, 316 A.2d 599 (Del. Ch. 1974) with *Gelco Corp. v. Coniston Partners*, 811 F.2d 414 (8th Cir. 1987). Other factors may also be considered, such as the possible expiration of the statute of limitations, although this would depend on the period of time during which the shareholder was aware of the grounds for the proceeding.

It should be noted that the shareholder bringing suit does not necessarily have to be the person making the demand. Only one demand need be made in order for the corporation to consider whether to take corrective action.

4. RESPONSE BY THE CORPORATION

There is no obligation on the part of the corporation to respond to the demand. However, if the corporation, after receiving the demand, decides to institute litigation or, after a derivative proceeding has commenced, decides to assume control of the litigation, the shareholder's right to commence or control the proceeding ends unless it can be shown that the corporation will not adequately pursue the matter. As stated in *Lewis v. Graves*, 701 F.2d 245, 247-48 (2d Cir. 1983):

The [demand] rule is intended "to give the derivative corporation itself the opportunity to take over a suit which was brought on its behalf in the first place, and thus to allow the directors the chance to occupy their normal status as conductors of the corporation's affairs." Permitting corporations to assume control over shareholder derivative suits also has numerous practical advantages. Corporate management may be in a better position to pursue alternative remedies, resolving grievances without burdensome and expensive litigation. Def

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erence to directors' judgments may also result in the termination of meritless actions brought solely for their settlement or harassment value. Moreover, where litigation is appropriate, the derivative corporation will often be in a better position to bring or assume the suit because of superior financial resources and knowledge of the challenged transactions. [Citations omitted.]

§ 7.43. STAY OF PROCEEDINGS

If the corporation commences an inquiry into the allegations made in the demand or complaint, the court may stay any derivative proceeding for such period as the court deems appropriate.

CROSS-REFERENCES

Demand, see § 7.41.

"Derivative proceeding" defined, see § 7.40.

OFFICIAL COMMENT

Section 7.43 provides that if the corporation undertakes an inquiry, the court may in its discretion stay the proceeding for such period as the court deems appropriate. This might occur where the complaint is filed 90 days after demand but the inquiry into matters raised by the demand has not been completed or where a demand has not been investigated but the corporation commences the inquiry after the complaint has been filed. In either case, it is expected that the court will monitor the course of the inquiry to ensure that it is proceeding expeditiously and in good faith.

§ 7.44. DISMISSAL

A derivative proceeding shall be dismissed by the court on motion by the corporation if one of the groups specified in

subsection (b) or subsection (e) has determined in good faith, after conducting a reasonable inquiry upon which its conclusions are based, that the maintenance of the derivative proceeding is not in the best interests of the corporation.

- (b) Unless a panel is appointed pursuant to subsection (e), the determination in subsection (a) shall be made by:
- (1) a majority vote of qualified directors present at a meeting of the board of directors if the qualified directors constitute a quorum; or
 - (2) a majority vote of a committee consisting of two or more qualified directors appointed by majority vote of qualified directors present at a meeting of the board of directors, regardless of whether such qualified directors constitute a quorum.
- (c) If a derivative proceeding is commenced after a determination has been made rejecting a demand by a shareholder, the complaint shall allege with particularity facts establishing either (1) that a majority of the board of directors did not consist of qualified directors at the time the determination was made or (2) that the requirements of subsection (a) have not been met.
- (d) If a majority of the board of directors consisted of qualified directors at the time the determination was made, the plaintiff shall have the burden of proving that the requirements of subsection (a) have not been met; if not, the corporation shall have the burden of proving that the requirements of subsection (a) have been met.
- (e) Upon motion by the corporation, the court may appoint a panel of one or more individuals to make a determination whether the maintenance of the derivative proceeding is in the best interests of the corporation. In such case, the plaintiff shall have the burden of proving that the requirements of subsection (a) have not been met.

CROSS-REFERENCES

Board of directors:
committees, see § 8.25.

meetings, see § 8.20.

quorum and voting, see § 8.24.

Demand, see § 7.41.

"Derivative proceeding" defined, see § 7.40.

"Qualified director" defined, see § 1.43.

"Shareholder" defined, see § 7.40.

OFFICIAL COMMENT

At one time, the Model Act did not expressly provide what happens when a board of directors properly rejects a demand to bring an action. In such event, judicial decisions indicate that the rejection should be honored and any ensuing derivative action should be dismissed. See *Aronson v. Lewis*, 473 A.2d 805, 813 (Del. 1984). The Model Act was also silent on the effect of a determination by a special litigation committee of qualified directors that a previously commenced derivative action should be dismissed. Section 7.44(a) specifically provides that the proceeding shall be dismissed if there is a proper determination that the maintenance of the proceeding is not in the best interests of the corporation. That determination can be made prior to commencement of the derivative action in response to a demand or after commencement of the action upon examination of the allegations of the complaint.

The procedures set forth in section 7.44 are not intended to be exclusive. As noted in the comment to section 7.42, there may be instances where a decision to commence an action falls within the authority of an officer of the corporation, depending upon the amount of the claim and the identity of the potential defendants.

1. THE PERSONS MAKING THE DETERMINATION

Section 7.44(b) prescribes the persons by whom the determination in subsection (a) may be made. Subsection (b) provides that the determination may be made (1) at a board meeting by a majority vote of qualified directors if the qualified directors constitute a quorum, or (2) by a majority vote of a committee consisting of two or more qualified directors appointed at a board

meeting by a vote of the qualified directors in attendance, regardless of whether they constitute a quorum. (For the definition of "qualified director," see section 1.43 and the related official comment.) These provisions parallel the mechanics for determining entitlement to indemnification (section 8.55) and for authorizing directors' conflicting interest transactions (section 8.62). Subsection (b)(2) is an exception to section 8.25 of the Model Act, which requires the approval of at least a majority of all the directors in office to create a committee and appoint members. This approach has been taken to respond to the criticism expressed in a few cases that special litigation committees suffer from a structural bias because of their appointment by vote of directors who at that time are not qualified directors. See *Hasan v. Trust Realty Investors*, 729 F.2d 372, 376-77 (6th Cir. 1984).

Subsection (e) provides, as an alternative, for a determination by a panel of one or more individuals appointed by the court. The subsection provides for the appointment only upon motion by the corporation. This would not, however, prevent the court on its own initiative from appointing a special master pursuant to applicable state rules of procedure. (Although subsection (b)(2) requires a committee of at least two qualified directors, subsection (e) permits the appointment by the court of only one person in recognition of the potentially increased costs to the corporation for the fees and expenses of an outside person.)

This panel procedure may be desirable in a number of circumstances. If there are no qualified directors available, the corporation may not wish to enlarge the board to add qualified directors or may be unable to find persons willing to serve as qualified directors. In addition, even if there are directors who are qualified, they may not be in a position to conduct the inquiry in an expeditious manner.

Appointment by the court should also eliminate any question about the qualifications of the individual or individuals constituting the panel making the determination. Although the corporation may wish to suggest to the court possible appointees, the court will not be bound by those suggestions and, in any case, will want to satisfy itself with respect to each candidate's impartiality. When the court appoints a panel, subsection (e) places the burden on the plaintiff to prove that the requirements of subsection (a) have not been met.

2. STANDARDS TO BE APPLIED

Section 7.44(a) requires that the determination, by the appropriate person or persons, be made "in good faith, after conducting a reasonable inquiry upon which their conclusions are based." The phrase "in good faith" modifies both the determination and the inquiry. This standard, which is also found in sections 8.30 (general standards of conduct for directors) and 8.51 (authority to indemnify) of the Model Act, is a subjective one, meaning "honestly or in an honest manner." See also "Corporate Director's Guidebook (Fourth Edition)," 59 Bus. Law. 1057, 1068 (2004). As stated in *Abella v. Universal Leaf Tobacco Co.*, 546 F. Supp. 795, 800 (E.D. Va. 1982), "the inquiry intended by this phrase goes to the spirit and sincerity with which the investigation was conducted, rather than the reasonableness of its procedures or basis for conclusions."

The word "inquiry" —rather than "investigation"—has been used to make it clear that the scope of the inquiry will depend upon the issues raised and the knowledge of the group making the determination with respect to those issues. In some cases, the issues may be so simple or the knowledge of the group so extensive that little additional inquiry is required. In other cases, the group may need to engage counsel and possibly other professionals to make an investigation and assist the group in its evaluation of the issues.

The phrase "upon which its conclusions are based" requires that the inquiry and the conclusions follow logically. This standard authorizes the court to examine the determination to ensure that it has some support in the findings of the inquiry. The burden of convincing the court about this issue lies with whichever party has the burden under subsection (d). This phrase does not require the persons making the determination to prepare a written report that sets forth their determination and the bases therefor, since circumstances will vary as to the need for such a report. There will be, in all likelihood, many instances where good corporate practice will commend such a procedure.

Section 7.44 is not intended to modify the general standards of conduct for directors set forth in section 8.30 of the Model Act, but rather to make those standards somewhat more explicit in the derivative proceeding context. In this regard, the qualified

directors making the determination would be entitled to rely on information and reports from other persons in accordance with section 8.30(d).

Section 7.44 is similar in several respects and differs in certain other respects from the law as it has developed in Delaware and been followed in a number of other states. Under the Delaware cases, the role of the court in reviewing the directors' determination varies depending upon whether the plaintiff is in a demand-required or demand-excused situation.

Since section 7.42 requires demand in all cases, the distinction between demand-excused and demand-required cases does not apply. Subsections (c) and (d) carry forward that distinction, however, by establishing pleading rules and allocating the burden of proof depending on whether there is a majority of qualified directors on the board. Subsection (c), like Delaware law, assigns to the plaintiff the threshold burden of alleging facts establishing that the majority of the directors on the board are not qualified. If there is a majority, then the burden remains with the plaintiff to plead and establish that the requirements of subsection (a) section 7.44(a) have not been met. If there is not a majority of qualified directors on the board, then the burden is on the corporation to prove that the issues delineated in subsection (a) have been satisfied; that is, the corporation must prove both the eligibility of the decision makers to act on the matter and the propriety of their inquiry and determination.

Thus, the burden of proving that the requirements of subsection (a) have not been met will remain with the plaintiff in several situations. First, where the determination to dismiss the derivative proceeding is made in accordance with subsection (b)(1), the burden of proof will generally remain with the plaintiff since the subsection requires a quorum of qualified directors and a quorum is normally a majority. See section 8.24. The burden will also remain with the plaintiff if a majority of qualified directors has appointed a committee under subsection (b)(2), and the qualified directors constitute a majority of the board. Under subsection (e), the burden of proof also remains with the plaintiff in the case of a determination by a panel appointed by the court.

The burden of proof will shift to the corporation, however, where a majority of the board members are not qualified and the determination is made by a committee under subsection (b)(2). It

can be argued that, if the directors making the determination under subsection (b)(2) are qualified and have been delegated full responsibility for making the decision, the composition of the entire board is irrelevant. This argument is buttressed by the section's method of appointing the group specified in subsection (b)(2), since it departs from the general method of appointing committees and allows only qualified directors, rather than a majority of the entire board, to appoint the committee that will make the determination. Subsection (d)'s response to objections suggesting structural bias is to place the burden of proof on the corporation (despite the fact that the committee making the determination is composed exclusively of qualified directors).

Finally, section 7.44 does not authorize the court to review the reasonableness of the determination to reject a demand or seek dismissal. This contrasts with the approach in some states that permits a court, at least in some circumstances, to review the merits of the determination (*see Zapata Corp. v. Maldonado*, 430 A. 2d 779, 789 (Del. 1981) and is similar to the approach taken in other states (*see Auerbach v. Bennett*, 393 N.E. 2d 994, 1002-03 (N.Y.1979).

3. PLEADING

The Model Act previously provided that the complaint in a derivative proceeding must allege with particularity either that demand had been made on the board of directors, together with the board's response, or why demand was excused. This requirement is similar to rule 23.1 of the Federal Rules of Civil Procedure. Since demand is now required in all cases, this provision is no longer necessary.

Subsection (c) sets forth a modified pleading rule to cover the typical situation where the plaintiff makes demand on the board, the board rejects that demand, and the plaintiff commences an action. In that scenario, in order to state a cause of action, subsection (c) requires the complaint to allege with particularity facts demonstrating either (1) that no majority of qualified directors exists or (2) why the determination made by qualified directors does not meet the standards in subsection (a). Discovery should be available to the plaintiff only after the plaintiff has successfully stated a cause of action by making either of these two showings.

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additional time is needed. The Texas statute also describes the effect of filing demand on the applicable statute of limitations.

For comparison to other state statutes, see the Annotation to section 7.40.

§ 7.44. DISMISSAL

- (a) A derivative proceeding shall be dismissed by the court on motion by the corporation if one of the groups specified in subsections (b) or (f) has determined in good faith after conducting a reasonable inquiry upon which its conclusions are based that the maintenance of the derivative proceeding is not in the best interests of the corporation.
- (b) Unless a panel is appointed pursuant to subsection (f), the determination in subsection (a) shall be made by:
 - (1) a majority vote of independent directors present at a meeting of the board of directors if the independent directors constitute a quorum; or
 - (2) a majority vote of a committee consisting of two or more independent directors appointed by majority vote of independent directors present at a meeting of the board of directors, whether or not such independent directors constituted a quorum.
- (c) None of the following shall by itself cause a director to be considered not independent for purposes of this section:
 - (1) the nomination or election of the director by persons who are defendants in the derivative proceeding or against whom action is demanded;
 - (2) the naming of the director as a defendant in the derivative proceeding or as a person against whom action is demanded; or
 - (3) the approval by the director of the act being challenged in the derivative proceeding or demand if the act resulted in no personal benefit to the director.

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- (d) If a derivative proceeding is commenced after a determination has been made rejecting a demand by a shareholder, the complaint shall allege with particularity facts establishing either (1) that a majority of the board of directors did not consist of independent directors at the time the determination was made or (2) that the requirements of subsection (a) have not been met.
- (e) If a majority of the board of directors does not consist of independent directors at the time the determination is made, the corporation shall have the burden of proving that the requirements of subsection (a) have been met. If a majority of the board of directors consists of independent directors at the time the determination is made, the plaintiff shall have the burden of proving that the requirements of subsection (a) have not been met.
- (f) The court may appoint a panel of one or more independent persons upon motion by the corporation to make a determination whether the maintenance of the derivative proceeding is in the best interests of the corporation. In such case, the plaintiff shall have the burden of proving that the requirements of subsection (a) have not been met.

CROSS-REFERENCES

Board of directors:

committees, see § 8.25.

meetings, see § 8.20.

quorum and voting, see § 8.24.

Demand, see § 7.41.

"Derivative proceeding" defined, see § 7.40.

"Shareholder" defined, see § 7.40.

OFFICIAL COMMENT

The prior version of the Model Act did not expressly provide what happens when a board of directors properly rejects a demand

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to bring an action. Judicial decisions indicate that a derivative action should be dismissed in these circumstances. See *Aronson v. Lewis*, 473 A.2d 805, 813 (Del. 1984). The prior version of the Model Act was also silent on the effect of a determination by a special litigation committee of independent directors that a previously commenced derivative action can be dismissed. Several state corporation laws have been amended to provide for action by such a committee. IND. CODE ANN. § 23-1-32-4 (Burns 1984 & Supp. 1988); N.D. CENT. CODE § 10-19.1-49 (1985). Section 7.44(a) specifically provides that the proceeding shall be dismissed if there is a proper determination that the maintenance of the proceeding is not in the best interests of the corporation. This determination can be made prior to commencement of the suit in response to a demand or after commencement upon examination of the allegations of the complaint.

The procedures set forth in section 7.44 are not intended to be exclusive. As noted in the comment to section 7.42, there may be instances where a decision to commence an action falls within the authority of an officer of the corporation depending upon the amount of the claim and the identity of the potential defendants.

1. THE PERSONS MAKING THE DETERMINATION

Section 7.44(b) prescribes the persons by whom the determination in subsection (a) may be made. The subsection provides that the determination may be made by a majority vote of independent directors if there is a quorum of independent directors, or by a committee of independent directors appointed by a vote of the independent directors. These provisions parallel the mechanics for determining entitlement to indemnification in section 8.55 of the Model Act. In this respect this clause is an exception to section 8.25 of the Model Act which requires the approval of at least a majority of all the directors in office to create a committee and appoint members. This approach has been taken to respond to the criticism expressed in a few cases that special litigation committees suffer from a structural bias because of their appointment by vote of non-independent directors. See *Hasan v. Cleve Trust Realty Investors*, 729 F.2d 372, 376-77 (6th Cir. 1984).

The decisions which have examined the qualifications of directors making the determination have required that they be both

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“disinterested” in the sense of not having a personal interest in the transaction being challenged as opposed to a benefit which devolves upon the corporation or all shareholders generally, and “independent” in the sense of not being influenced in favor of the defendants by reason of personal or other relationships. See, e.g., *Aronson v. Lewis*, 473 A.2d 805, 812–16 (Del. 1984). Only the word “independent” has been used in section 7.44(b) because it is believed that this word necessarily also includes the requirement that a person have no interest in the transaction. The concept of an independent director is not intended to be limited to non-officer or “outside” directors but may in appropriate circumstances include directors who are also officers.

Many of the special litigation committees involved in the reported cases consisted of directors who were elected after the alleged wrongful acts by the directors who were named as defendants in the action. Subsection (c)(1) makes it clear that the participation of non-independent directors or shareholders in the nomination or election of a new director shall not prevent the new director from being considered independent. This sentence therefore rejects the concept that the mere appointment of new directors by the non-independent directors makes the new directors not independent in making the necessary determination because of an inherent structural bias. Clauses (2) and (3) also confirm the decisions by a number of courts that the mere fact that a director has been named as a defendant or approved the action being challenged does not cause the director to be considered not independent. See *Aronson v. Lewis*, 473 A.2d 805, 816 (Del. 1984); *Lewis v. Graves*, 701 F.2d 245 (2d Cir. 1983). It is believed that a court will be able to assess any actual bias in deciding whether the director is independent without any presumption arising out of the method of the director’s appointment, the mere naming of the director as a defendant, or the director’s approval of the act where the director received no personal benefit from the transaction.

Subsection (f) also provides for a determination by a panel of one or more independent persons appointed by the court. Cf. VIRGINIA STOCK CORP. ACT § 13.1-672D (1987) (court may appoint a committee of two or more persons). The subsection provides for the appointment only upon motion by the corporation. This would not, however, prevent the court on its own initiative from

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appointing a special master pursuant to applicable state rules of procedure.

This procedure may be desirable in a number of circumstances. If there are no independent directors available, the corporation may not wish to enlarge the board to add independent directors or may be unable to find persons willing to serve as independent directors. In addition, if there are independent directors, they may not have the available time to conduct the inquiry in an expeditious manner.

Appointment by the court should also eliminate any question about the independence of the person making the determination. Although the corporation may wish to suggest to the court possible appointees, the court will not be bound by these suggestions and, in any case, will want to satisfy itself with respect to independence at the time the person is appointed. When the court appoints a panel, section 7.44(f) places the burden on the plaintiff to prove that the requirements of section 7.44(a) have not been met.

Although subsection (b)(2) requires a committee of at least two directors, subsection (f) permits the appointment of only one person in recognition of the potentially increased costs to the corporation for the fees and expenses of an outside person.

2. STANDARD TO BE APPLIED

Section 7.44(a) requires that the determination be made by the appropriate persons in good faith after conducting a reasonable inquiry upon which their conclusions are based. The word "inquiry" rather than "investigation" has been used to make it clear that the scope of the inquiry will depend upon the issues raised and the knowledge of the group making the determination with respect to the issues. In some cases, the issues may be so simple or the knowledge of the group so extensive that little additional inquiry is required. In other cases, the group may need to engage counsel and other professionals to make an investigation and assist the group in its evaluation of the issues.

The phrase "in good faith" modifies both the determination and the inquiry. The test, which is also included in sections 8.30 (general standards of conduct for directors) and 8.51 (authority to indemnify), is a subjective one, meaning "honestly or in an

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honest manner.” “The Corporate Director’s Guidebook,” 33 BUS. LAW. 1595, 1601 (1978). As stated in *Abella v. Universal Leaf Tobacco Co.*, 546 F. Supp. 795, 800 (E.D. Va. 1982), “the inquiry intended by this phrase goes to the spirit and sincerity with which the investigation was conducted, rather than the reasonableness of its procedures or basis for conclusions.”

The phrase “upon which its conclusions are based” requires that the inquiry and the conclusions follow logically. This provision authorizes the court to examine the determination to ensure that it has some support in the findings of the inquiry. The burden of convincing the court about this issue lies with whichever party has the burden under section 7.44(e). This phrase does not require the persons making the determination to prepare a written report that sets forth their determination and the bases therefor, since circumstances will vary as to the need for such a report. There may, however, be many instances where good corporate practice will commend such a procedure.

Section 7.44 is not intended to modify the general standards of conduct for directors set forth in section 8.30 of the Model Act, but rather to make those standards somewhat more explicit in the derivative proceeding context. In this regard, the independent directors making the determination would be entitled to rely on information and reports from other persons in accordance with section 8.30(b).

Section 7.44 is similar in several respects and differs in certain other respects from the law as it has developed in Delaware and been followed in a number of other states. Under the Delaware cases, the role of the court in reviewing the board’s determination varies depending upon whether the plaintiff is in a demand-required or demand-excused situation. Demand is excused only if the plaintiff pleads particularized facts that create a reasonable doubt that a majority of directors at the time demand would be made are independent or disinterested, or that the challenged transaction was the product of a valid exercise of business judgment by the approving board. *Aronson v. Lewis*, 473 A.2d 805, 814 (Del. 1984); *Levine v. Smith*, 591 A.2d 194 (Del. 1991). If the plaintiff fails to make these two showings, demand is required. Since the *Aronson* requirements are difficult to satisfy, the plaintiff normally must make demand on the board.

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In the unusual case where the plaintiff's demand is excused under either of the *Aronson* tests, the plaintiff has standing to bring the derivative suit. If the corporation seeks to reassert its right to control the litigation, the corporation will form a special litigation committee to determine if the litigation is in the best interests of the corporation. If the corporation files a motion to dismiss the litigation based upon the recommendation of the special committee, Delaware law requires the corporation to bear the burden of proving the independence of the committee, the reasonableness of its investigation, and the reasonableness of the bases of its decision reflected in the motion. *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981). *Zapata* also permits the court a discretionary second step to review the special committee's decision by invoking the court's "independent business judgment." *Id.* at 789.

In the usual scenario where demand is not excused, the shareholder must demand that the board take action and the *Zapata* principles do not apply. The board or special committee of independent directors decides whether the corporation should take the action the shareholder requests or respond in some other way. As in the case of all board decisions, the board's response to the shareholder's demand is presumptively protected by the traditional business judgment rule. *Allison v. General Motors Corp.*, 604 F. Supp. 1106, 1122 (D. Del. 1985). As a result, the shareholder in filing suit bears the normal burden of creating by particularized pleadings a reasonable doubt that the board's response to the demand was wrongful. *Levine v. Smith*, No. 591 A.2d 194, 210 (Del. 1991). The plaintiff must allege with particularity a lack of good faith, care, independence, or disinterestedness by the directors in responding to the demand.

In contrast to Delaware's approach, some jurisdictions have adopted uniform tests to judge both demand-required and demand-excused situations. For example, in New York, judicial review is always limited to an analysis of the independence and good faith of the board or committee and the reasonableness of its investigation; the court does not examine the reasonableness of the bases for the board's decision, nor does the court have the discretionary authority to use its independent business judgment. *Auerbach v. Bennett*, 47 N.Y.2d 619, 633-34, 419 N.Y.S.2d 920, 928-29, 393 N.E.2d 994, 1002-03 (1979). In contrast, the North

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Carolina Supreme Court has interpreted that state's statutory provisions on derivative actions as requiring the application of the *Zapata* criteria in both demand-required and demand-excused cases. *Alford v. Shaw*, 358 S.E.2d 323, 327 (N.C. 1987).

Since section 7.42 requires demand in all cases, the distinction between demand-excused and demand-required cases does not apply. Subsections (d) and (e) of section 7.44 carry forward the distinction, however, by establishing pleading rules and allocating the burden of proof depending on whether there is a majority of independent directors. Subsection (d), like Delaware law, assigns the plaintiff the threshold burden of alleging facts establishing that majority of the board is not independent. If there is an independent majority, the burden remains with the plaintiff to plead and establish that the requirements of section 7.44(a) have not been met. If there is no independent majority, the burden is on the corporation on the issues delineated in section 7.44(a). In this case, the corporation must prove both the independence of the decisionmakers and the propriety of the inquiry and determination.

Subsections (d) and (e) of section 7.44 thus follow the first *Aronson* standard in allocating the burden of proof depending on whether the majority of the board is independent. The Committee on Corporate Laws decided, however, not to adopt the second *Aronson* standard for excusing demand (and thus shifting the burden to the corporation) based on whether the decision of the board that decided the challenged transaction is protected by the business judgment rule. The committee believes that the only appropriate concern in the context of derivative litigation is whether the board considering the demand has a disabling conflict. See *Starrels v. First Nat'l Bank*, 870 F.2d 1168, 1172-76 (7th Cir. 1989) (Easterbrook, J., concurring).

Thus, the burden of proving that the requirements of 7.44(a) have not been met will remain with the plaintiff in several situations. First, in subsection (b)(1), the burden of proof will generally remain with the plaintiff since the subsection requires a quorum of independent directors and a quorum is normally a majority. See section 8.24. The burden will also remain with the plaintiff if there is a majority of independent directors which appoints the committee under subsection (b)(2). Under section

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7.44(f), the burden of proof also remains with the plaintiff in the case of a determination by a panel appointed by the court.

The burden of proof will shift to the corporation, however, where a majority of directors is not independent, and the determination is made by the group specified in subsection (b)(2). It can be argued that, if the directors making the determination under subsection (b)(2) are independent and have been delegated full responsibility for making the decision, the composition of the entire board is irrelevant. This argument is buttressed by the section's method of appointing the group specified in subsection (b)(2) since subsection (b)(2) departs from the general method of appointing committees and allows only independent directors, rather than a majority of the entire board, to appoint the committee which will make the determination. Nevertheless, despite the argument that the composition of the board is irrelevant in these circumstances, the Committee on Corporate Laws adopted the provisions of subsections (b)(2) and (e) of section 7.44 to respond to concerns of structural bias.

Finally, section 7.44 does not authorize the court to review the reasonableness of the determination. As discussed above, the phrase in section 7.44(a) "upon which its conclusions are based" limits judicial review to whether the determination has some support in the findings of the inquiry.

3. PLEADING

Former section 7.40(b) provided that the complaint in a derivative proceeding must allege with particularity whether demand has been made on the board of directors and the board's response or why demand was excused. This requirement is similar to rule 23.1 of the Federal Rules of Civil Procedure. Since demand is now required in all cases, this provision is no longer necessary.

Subsection (d) sets forth a modified pleading rule to cover the typical situation where plaintiff makes demand on the board, the board rejects that demand, and the plaintiff commences an action. In that scenario, in order to state a cause of action, subsection (d) requires the complaint to allege facts with particularity demonstrating either (1) that no majority of independent directors exists or (2) why the determination does not meet the standards in subsection (a). Discovery is available to the plaintiff only after the

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plaintiff has successfully stated a cause of action by making either of these two showings.

ANNOTATION

HISTORY

See the Annotation to section 7.40.

STATUTES

Ariz. Rev. Stat. Ann. § 10-744
Conn. Bus. Corp. Act § 33-724 (West)
Fla. Stat. Ann. § 607.07401(3)
Ga. Code Ann. § 14-2-744
Hawaii Rev. Stat. § 414-175
Idaho Code § 30-1-744
Iowa Code Ann. § 490.744
13-C Me. Rev. Stat. Ann. § 755
Mich. Comp. Laws Ann. §§ 450.1491a, 450.1495 (West)
Miss. Code Ann. § 79-4-7.44
Mont. Code Ann. § 35-1-545
Neb. Rev. Stat. § 21-2074
N.H. Rev. Stat. Ann. § 293-A:7.44
N.C. Gen. Stat. § 55-7-44
Tex. Bus. Corp. Act Ann. art. 5.14G, H (Vernon)
Va. Code § 13.1-672.4
Wis. Stat. Ann. § 180.0744 (West)
Wyo. Stat. § 17-16-744

For a list of other statutes dealing with derivative proceedings, see the Annotation to section 7.40.

STATUTORY COMPARISON

Arizona, Connecticut, Georgia, Hawaii, Idaho, Iowa, Maine, Mississippi, Montana, Nebraska, New Hampshire, North Carolina, and Wisconsin have adopted section 7.44 with little substantive change.

Florida has no counterpart to subsection (c); its statute further provides that the court “may,” rather than “shall,” dismiss the proceeding, refers to “investigation,” rather than “inquiry,” and imposes the burden of showing good faith and reasonable investigation on the corporation in all instances. Michigan has no provision similar to section 7.44(c) and also requires that the corporation bear the burden of establishing good faith and reasonable investigation unless the determination is made by a panel of one

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or more disinterested persons or “all” disinterested directors; a “disinterested” person is defined as someone who is not a party to the proceeding or against whom the claim asserted is “frivolous or insubstantial.”

In Texas, one or more “disinterested and independent” directors may appoint a committee consisting of two or more disinterested and independent directors; plaintiff bears the burden of proof if the determination to dismiss is made by a majority of independent and disinterested directors or by a panel of independent persons; if a majority of the board is not independent and disinterested and a committee makes the determination, the burden of proof is on the corporation unless it provides “prima facie evidence” that the committee members making the determination were independent and disinterested.

The Virginia provision substitutes a “review and evaluation of the allegations made in the complaint” and requires that the reviewing body submit in support of its motion to dismiss “a short and concise statement of the reasons for its determination”; the plaintiff has the burden of proof in all cases, except where the complaint pleads with particularity “facts raising a substantial question” concerning the independence of the board or board committee making the determination to dismiss.

In Wyoming, a determination to dismiss may be made only by an independent panel appointed by the court.

For comparison to other state statutes, see the Annotation to section 7.40.

§ 7.45. DISCONTINUANCE OR SETTLEMENT

A derivative proceeding may not be discontinued or settled without the court’s approval. If the court determines that a proposed discontinuance or settlement will substantially affect the interests of the corporation’s shareholders or a class of shareholders, the court shall direct that notice be given to the shareholders affected.

CROSS-REFERENCES

“Derivative proceeding” defined, see § 7.40.

“Shareholder” defined, see § 7.40.

Model Nonprofit Corporation Act

Third Edition

Official Text with Official Comments
and Statutory Cross-references
Adopted August 2008

Committee on Nonprofit Organizations



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[Subchapter] C SECRETARY OF STATE

§ 1.30. Powers.

§ 1.30. POWERS

The secretary of state has the powers reasonably necessary to perform the duties required of the secretary of state by this [act].

Source Note: Patterned after Model Business Corporation Act, 3d Ed. (2002) § 1.30. Reenactment of Revised Model Nonprofit Corporation Act (1987) § 1.30.

CROSS-REFERENCES

Administrative dissolution, see § 14.20.

Revocation of certificate of authority of foreign nonprofit corporation, see Subch. 15C.

Secretary of state's filing duty, see § 1.25.

OFFICIAL COMMENT

Section 1.30 is intended to grant the secretary of state the authority necessary for the efficient performance of the filing and other duties imposed by the act but is not intended to give the secretary of state general authority to establish public policy. The most important aspects of a modern corporation statute relate to the creation and maintenance of relationships among persons interested in or involved with a corporation. These relationships basically should be a matter of concern to the parties involved and not subject to regulation or interpretation by the secretary of state. Further, even in situations where it is claimed that the corporation has been formed or is being operated for purposes that may violate the public policies of the state, the secretary of state generally should not be the governmental official who determines the scope of public policy through administration of the filing responsibilities under the act. Rather, the attorney general may seek to enjoin the illegal conduct or to dissolve involuntarily the offending corporation.

[Subchapter] D DEFINITIONS

§ 1.40. [Act] definitions.

§ 1.41. Notice.

§ 1.40. [ACT] DEFINITIONS

In this [act], unless the context clearly indicates otherwise:

- (1) "Articles" or "articles of incorporation" means the original articles of incorporation, all amendments thereof, and any other records filed with the secretary of state with respect to a domestic nonprofit corporation under any provision of this [act] except Section 16.21. If any record filed under this [act] restates the articles in their entirety, thenceforth the articles shall not include any prior filings.

Source Note: Patterned after Model Business Corporation Act, 3d Ed. (2002) § 1.40(1). Compare Revised Model Nonprofit Corporation Act (1987) § 1.40.

- (2) "Board" or "board of directors" means the group of individuals responsible for the management of the activities and affairs of the nonprofit corporation, regardless of the name used to refer to the group. The term includes a designated body to the extent:
 - (i) the authority, powers, or functions of the board have been vested in, or are exercised by, the designated body; and
 - (ii) the provision of this [act] in which the term appears is relevant to the discharge by the designated body of its authority, powers, or functions.

Source Note: Patterned in part after first two sentences of 15 PA. CONS. STAT. § 5103 (2008) ("board of directors"). Compare Revised Model Nonprofit Corporation Act (1987) § 1.40(3).

- (3) "Business corporation" or "domestic business corporation" means a corporation incorporated under the laws

Source Note: New.

- (26) "Governmental subdivision" includes an authority, county, district, and municipality.

Source Note: Patterned after Model Business Corporation Act, 3d Ed. (2002) § 1.40(11). Reenactment of Revised Model Nonprofit Corporation Act (1987) § 1.40(17).

- (27) "Governor" means a person by or under whose authority the powers of an unincorporated entity are exercised and under whose direction the business, activities, or affairs of the entity are managed pursuant to the organic law and organic records of the entity.

Source Note: Patterned after Model Entity Transactions Act § 102(16).

- (28) "Includes" denotes a partial definition.

Source Note: Patterned after Model Business Corporation Act, 3d Ed. (2002) § 1.40(12). Reenactment of Revised Model Nonprofit Corporation Act (1987) § 1.40(18).

- (29) "Individual" means a natural person.

Source Note: Patterned after Model Business Corporation Act, 3d Ed. (2002) § 1.40(13). Compare Revised Model Nonprofit Corporation Act (1987) § 1.40(19).

- (30) "Interest" means either or both of the following rights under the organic law of an unincorporated entity:

- (i) the right to receive distributions from the entity either in the ordinary course or upon liquidation; or
- (ii) the right to receive notice or vote on issues involving its internal affairs, other than as an agent, assignee, proxy, or person responsible for managing its business, activities, or affairs.

Source Note: Patterned after Model Business Corporation Act, 3d Ed. (2002) § 1.40(13A).

- (31) "Interest holder" means a person who holds of record an interest.

Source Note: Patterned after Model Business Corporation Act, 3d Ed. (2002) § 1.40(13B).

- (32) "Interest holder liability" means personal liability for a debt, obligation, or liability of a domestic or foreign business or nonprofit corporation or unincorporated entity that is imposed on a person:

- (i) solely by reason of the person's status as a shareholder, interest holder, or member; or
- (ii) by the articles of incorporation, bylaws, or an organic record pursuant to a provision of the organic law authorizing the articles, bylaws, or an organic record to make one or more specified shareholders, interest holders, or members liable in their capacity as shareholders, interest holders, or members for all or specified debts, obligations, or liabilities of the entity.

Source Note: Patterned after Model Business Corporation Act, 3d Ed. (2002) § 1.40(15C).

- (33) "Internal Revenue Code" means the Internal Revenue Code of 1986 (Public Law 99-514, 26 U.S.C. § 1 et seq.), as amended.

Source Note: New.

- (34) "Material interest" means an actual or potential benefit or detriment, other than one that would devolve on the nonprofit corporation or the members generally, that would reasonably be expected to impair the objectivity of an individual's judgment when participating in the action to be taken.

Source Note: Patterned after Model Business Corporation Act, 3d Ed. (2005) § 1.43(b)(2).

- (35) "Material relationship" means a familial, financial, professional, employment, or other relationship that would reasonably be expected to impair the objectivity of an individual's judgment when participating in the action to be taken.

Source Note: Patterned after Model Business Corporation Act, 3d Ed. (2005) § 1.43(b)(1).

(36) "Means" denotes an exhaustive definition.

Source Note: Patterned after Model Business Corporation Act, 3d Ed. (2002) § 1.40(14). Substantially a reenactment of Revised Model Nonprofit Corporation Act (1987) § 1.40(20).

(37) "Member" means:

- (i) A person who has the right, in accordance with the articles of incorporation or bylaws and not as a delegate, to select or vote for the election of directors or delegates or to vote on any type of fundamental transaction. See Section 6.02(d) (admission).
- (ii) A designated body to the extent:
 - (A) the authority, powers, or functions of the members have been vested in, or are exercised by, the designated body; and
 - (B) the provision of this [act] in which the term appears is relevant to the discharge by the designated body of its authority, powers, or functions.

Source Note: Compare Revised Model Nonprofit Corporation Act (1987) § 1.40(21).

(38) "Membership" means the rights and any obligations of a member in a nonprofit corporation.

Source Note: Patterned in part after Revised Model Nonprofit Corporation Act (1987) § 1.40(22). Compare Model Business Corporation Act, 3d Ed. (2002) § 1.40(14A).

(39) "Membership corporation" means a nonprofit corporation whose articles of incorporation or bylaws provide that it shall have members.

Source Note: New.

(40) "Nonfiling entity" means an unincorporated entity that is not created by filing a public organic record.

Source Note: Patterned after proposed Model Business Corporation Act, 3d Ed. (2002) § 1.40(14B).

(41) "Nonmembership corporation" means a nonprofit corporation whose articles of incorporation or bylaws do not provide that it shall have members.

Source Note: New.

(42) "Nonqualified foreign corporation" means a foreign corporation that is not authorized to conduct activities in this state.

Source Note: New.

(43) "Notice" is provided for in Section 1.41.

Source Note: Patterned after Model Business Corporation Act, 3d Ed. (2002) § 1.40(15). Reenactment of Revised Model Nonprofit Corporation Act (1987) § 1.40(24).

(44) "Officer" includes:

- (i) a person who is an officer as provided in Section 8.40; and
- (ii) if a nonprofit corporation is in the hands of a custodian, receiver, trustee or other court-appointed fiduciary, that fiduciary or any person appointed by that fiduciary to act as an officer for any purpose under this [act].

Source Note: Patterned after 15 PA. CONS. STAT. § 5103 (2008) ("officer").

(45) "Organic law" means the statute principally governing the internal affairs of a domestic or foreign business or nonprofit corporation or unincorporated entity.

Source Note: Patterned after Model Business Corporation Act, 3d Ed. (2002) § 1.40(15B).

(46) "Organic record" means a public organic record or the private organic rules.

Source Note: Patterned after Model Business Corporation Act, 3d Ed. (2002) § 1.40(15A).

CROSS-REFERENCES

"Derivative proceeding" defined, see § 13.01.

OFFICIAL COMMENT

The act and the statutes of many states have long required that a plaintiff must have been a member at the time of the transaction in question. This rule has been criticized as being unduly narrow and technical and unnecessary to prevent the transfer or purchase of lawsuits.

The decision to retain the rule of contemporaneous status as a member in Section 13.02(b) was based primarily on the view that it was simple, clear, and easy to apply. Further, there has been no persuasive showing that the contemporaneous membership rule has prevented the litigation of substantial suits. Where the plaintiff is a director or member of a designated body, however, the plaintiff need only have that status at the time the proceeding is commenced.

Section 13.02 does not permit a creditor to commence a derivative proceeding.

§ 13.03. DEMAND

A person may not commence a derivative proceeding until:

- (1) a demand in the form of a record has been delivered to the nonprofit corporation to take suitable action; and
- (2) 90 days have expired from the date the demand was effective unless the person has earlier been notified that the demand has been rejected by the corporation or unless irreparable injury to the corporation would result by waiting for the expiration of the 90-day period.

Source Note: Patterned after Model Business Corporation Act, 3d Ed. (2002) § 7.42. Compare Revised Model Nonprofit Corporation Act (1987) § 6.30(c).

CROSS-REFERENCES

"Derivative proceeding" defined, see § 13.01.

OFFICIAL COMMENT

Section 13.03 requires a demand on the nonprofit corporation in all cases. The demand must be made at least 90 days before commencement of suit unless irreparable injury to the corporation would result. This approach has been adopted for two reasons. First, even though no director may be independent, the demand will give the board of directors the opportunity to re-examine the act complained of in the light of a potential lawsuit and take corrective action. Secondly, the provision eliminates the time and expense of the litigants and the court involved in litigating the question whether demand is required. It is believed that requiring a demand in all cases does not impose an onerous burden since a relatively short waiting period of 90 days is provided and this period may be shortened if irreparable injury to the corporation would result by waiting for the expiration of the 90-day period. Moreover, the cases in which demand is excused are relatively rare. Many plaintiffs' counsel as a matter of practice make a demand in all cases rather than litigate the issue whether demand is excused.

1. *Form of Demand*

Section 13.03 specifies only that the demand must be in the form of a record. The demand should, however, set forth the facts concerning membership and be sufficiently specific to apprise the nonprofit corporation of the action sought to be taken and the ground for that action so that the demand can be evaluated. See *Allison v. General Motors Corp.*, 604 F. Supp. 1106, 1117 (D. Del. 1985). Detailed pleading is not required since the corporation can contact the member for clarification if there are any questions. In keeping with the spirit of this section, the specificity of the demand should not become a new source of dilatory motions.

2. *Upon Whom Demand Should Be Made*

Section 13.03 states that demand shall be made upon the nonprofit corporation. Reference is not made specifically to the board of directors since there may be instances, such as a decision

(b) See Section 13.06 (applicability to foreign corporations).

Source Note: Patterned after Model Business Corporation Act, 3d Ed. (2002) § 7.43. Compare Revised Model Nonprofit Corporation Act (1987) § 6:30(c). Subsection (b) is new.

CROSS-REFERENCES

Demand, see § 13.03.

"Derivative proceeding" defined, see § 13.01.

OFFICIAL COMMENT

Section 13.04 provides that if the nonprofit corporation undertakes an inquiry, the court may in its discretion stay the proceeding for such period as the court deems appropriate. This might occur where the complaint is filed 90 days after demand but the inquiry into matters raised by the demand has not been completed or where a demand has not been investigated but the corporation commences the inquiry after the complaint has been filed. In either case, it is expected that the court will monitor the course of the inquiry to ensure that it is proceeding expeditiously and in good faith.

§ 13.05. DISMISSAL

- (a) A derivative proceeding shall be dismissed by the court on motion by the nonprofit corporation if one of the groups specified in subsection (b) or (e) has determined in good faith after conducting a reasonable inquiry upon which its conclusions are based that the maintenance of the derivative proceeding is not in the best interests of the corporation.
- (b) Unless a panel is appointed pursuant to subsection (e), the determination in subsection (a) shall be made by:
 - (1) a majority vote of independent directors present at a meeting of the board of directors if the independent directors constitute a quorum; or
 - (2) a majority vote of a committee consisting of two or more independent directors appointed by majority vote of

independent directors present at a meeting of the board of directors, whether or not such independent directors constituted a quorum.

- (c) If a derivative proceeding is commenced after a determination has been made rejecting a demand by a member, the complaint must allege with particularity facts establishing either:
 - (1) that a majority of the board of directors did not consist of independent directors at the time the determination was made; or
 - (2) that the requirements of subsection (a) have not been met.
- (d) If a majority of the board of directors does not consist of independent directors at the time the determination is made, the nonprofit corporation has the burden of proving that the requirements of subsection (a) have been met. If a majority of the board of directors consists of independent directors at the time the determination is made, the plaintiff has the burden of proving that the requirements of subsection (a) have not been met.
- (e) The court may appoint a panel of one or more independent persons upon motion by the nonprofit corporation to make a determination whether the maintenance of the derivative proceeding is in the best interests of the corporation. In such case, the plaintiff shall have the burden of proving that the requirements of subsection (a) have not been met.
- (f) A person is independent for purposes of this section if the person does not have:
 - (1) a material interest in the outcome of the proceeding, or
 - (2) a material relationship with a person who has such an interest.
- (g) None of the following shall by itself cause a director to be considered not independent for purposes of this section:
 - (1) the nomination, election, or appointment of the director by persons who are defendants in the derivative proceeding or against whom action is demanded;

- (2) the naming of the director as a defendant in the derivative proceeding or as a person against whom action is demanded; or
- (3) the approval by the director of the act being challenged in the derivative proceeding or demand if the act resulted in no personal benefit to the director.

Source Note: Patterned after Model Business Corporation Act, 3d Ed. (2002) § 7.44.

CROSS-REFERENCES

Board of directors:

committees, see § 8.25.

meetings, see § 8.20.

quorum and voting, see § 8.24.

Demand, see § 13.03.

"Derivative proceeding" defined, see § 13.01.

"Material interest" defined, see § 1.40.

"Material relationship" defined, see § 1.40.

OFFICIAL COMMENT

When a board of directors properly rejects a demand to bring an action, judicial decisions indicate that the derivative action should be dismissed. See *Aronson v. Lewis*, 743 A.2d 805, 813 (Del. 1984). The prior version of the act was silent on the effect of a determination by a special litigation committee of independent directors that a previously commenced derivative action can be dismissed. Several state business corporation laws have been amended to provide for action by such a committee. See, e.g. IND. CODE ANN. § 23-1-32-4 (Burns 1984 & Supp. 1988); N.D. CENT. CODE § 10-19.149 (1985). This section adopts for nonprofit corporations those developments in business corporation law. Section 13.05(a) specifically provides that the proceeding shall be dismissed if there is a proper determination that the maintenance of the proceeding is not in the best interests of the corporation. This determination can be made prior to commencement of the

suit in response to a demand or after the commencement upon examination of the allegations of the complaint.

The procedures set forth in Section 13.05 are not intended to be exclusive. As noted in the comment to Section 13.03, there may be instances where a decision to commence an action falls within the authority of an officer of the nonprofit corporation depending upon the amount of the claim and the identity of the potential defendants.

1. *The Persons Making the Determination*

Section 13.05(b) prescribes the persons by whom the determination in subsection (a) may be made. The subsection provides that the determination may be made by a majority vote of independent directors if there is a quorum of independent directors, or by a committee of independent directors appointed by a vote of the independent directors. These provisions parallel the mechanics for determining entitlement to indemnification in Section 8.55. In this respect this clause is an exception to Section 8.25 which required the approval of at least a majority of all the directors in office to create a committee and appoint members. This approach has been taken to respond to the criticism expressed in a few cases that special litigation committees suffer from a structural bias because of their appointment by a vote of non-independent directors. See *Hasan v. Cleve Trust Realty Investors*, 729 F.2d 372, 376-77 (6th Cir. 1984).

The decisions that have examined the qualifications of directors making the determination have required that the directors be both "disinterested" in the sense of not having a personal interest in the transaction being challenged (as opposed to a benefit which devolves upon the corporation or all shareholders generally) and "independent" in the sense of not being influenced in favor of the defendants by reason of personal or other relationships. See, e.g., *Aronson v. Lewis*, 743 A.2d 805, 812-16 (Del. 1984). Only the word "independent" has been used in Section 13.05(b) because it is believed that a person who has an interest in the transaction would not be independent. The concept of an independent director is not intended to be limited to nonofficer

or "outside" directors but may in appropriate circumstances include directors who are also officers.

Many of the special litigation committees involved in the reported cases consisted of directors who were elected after the alleged wrongful acts by the directors who were named as defendants in the action. Section 13.05(g)(1) makes it clear that the participation of non-independent directors or members in the nomination, election, or appointment of a new director will not prevent the new director from being considered independent. This sentence therefore rejects the concept that the mere appointment of new directors by the non-independent directors makes the new directors not independent in making the necessary determination because of an inherent structural bias. Clauses (2) and (3) also confirm the decisions by a number of courts that the mere fact that a director has been named as a defendant or approved the action being challenged does not cause the director to be considered not independent. See *Aronson v. Lewis*, 743 A.2d 805, 816 (Del. 1984); *Lewis v. Graves*, 701 F.2d 245 (2d Cir. 1983). It is believed that a court will be able to assess any actual bias in deciding whether the director is independent without any presumption arising out of the method of the director's appointment, the mere naming of the director as a defendant, or the director's approval of the act where the director received no personal benefit from the transaction.

Section 13.05(e) also provides for a determination by a panel of one or more independent persons appointed by the court. Cf. VA. CODE ANN. § 13.1-672D (1987) (court may appoint a committee of two or more persons). The subsection provides for the appointment only upon motion by the nonprofit corporation. This would not, however, prevent the court on its own initiative from appointing a special master pursuant to applicable state rules of procedure.

This procedure may be desirable in a number of circumstances. If there are no independent directors available, the nonprofit corporation may not wish to enlarge the board to add independent directors or may be unable to find persons willing to serve as independent directors. In addition, if there are inde-

pendent directors, they may not have the available time to conduct the inquiry in an expeditious manner.

Appointment by the court should also eliminate any question about the independence of the person making the determination. Although the nonprofit corporation may wish to suggest to the court possible appointees, the court will not be bound by these suggestions and, in any case, will want to satisfy itself with respect to independence at the same time the person is appointed.

Although subsection (b)(2) requires a committee of at least two directors, subsection (e) permits the appointment of only one person in recognition of the potentially increased costs to the nonprofit corporation for the fees and expenses of an outside person.

Under Section 8.12, a designated body may perform the functions of the board of directors under this section.

2. Standards to Be Applied

Section 13.05(a) requires that the determination be made by the appropriate persons in good faith after conducting a reasonable inquiry upon which their conclusions are based. The word "inquiry" rather than "investigation" has been used to make it clear that the scope of the inquiry will depend upon the issues raised and knowledge of the group making the determination with respect to the issues. In some cases, the issues may be so simple or the knowledge of the group so extensive that little additional inquiry is required. In other cases, the group may need to engage counsel and other professionals to make an investigation and assist the group in its evaluation of the issues.

The phrase "in good faith" modifies both the determination and inquiry. The test, which is also included in Section 8.30 (general standards of conduct for directors) and 8.51 (authority to indemnify), is a subjective one, meaning "honestly or in an honest manner." The American Bar Association, *The Corporate Director's Guidebook*, 33 BUS. LAW. 1595, 1601 (1978). As stated in *Abella v. Universal Leaf Tobacco Co.*, 546 F. SUPP. 795, 800 (E.D. Va. 1982), "the inquiry intended by this phrase goes to the spirit and sincerity with which the investigation was conducted,

rather than the reasonableness of its procedures or basis for conclusions."

The phrase "upon which its conclusions are based" requires that the inquiry and the conclusions follow logically. This provision authorizes the court to examine the determination to ensure that it has some support in the findings of the inquiry. The burden of convincing the court about this issue lies with whichever party has the burden under Section 13.05(d). This phrase does not require the persons making the determination to prepare a report that sets forth their determination and the bases therefore, since circumstances will vary as to the need for such a report. There may, however, be many instances where good corporate practice will commend such a procedure.

Section 13.05 is not intended to modify the general standards of conduct for directors set forth in Section 8.30 of the act, but rather to make those standards somewhat more explicit in the derivative proceeding contest. In this regard, the independent directors making the determination would be entitled to rely on information and reports from other persons in accordance with Section 8.30(b).

Section 13.05 is similar in several respects and differs in certain other respects from the law as it has developed in Delaware and been followed in a number of other states. Under the Delaware cases, the role of the court in reviewing the board's determination varies depending upon whether the plaintiff is in a demand-required or demand-excused situation. Demand is excused only if the plaintiff pleads particularized facts that create a reasonable doubt that a majority of directors at the time demand would be made are independent or disinterested, or that the challenged transaction was the product of a valid exercise of business judgment by the approving board. *Aronson v. Lewis*, 743 A.2d 805, 814 (Del. 1984); *Levine v. Smith*, 591 A.2d 194 (Del. 1991). If the plaintiff fails to make these two showings, demand is required. Since the *Aronson* requirements are difficult to satisfy, the plaintiff normally must make demand on the board.

In the unusual case where the plaintiff's demand is excused under either of the *Aronson* tests, the plaintiff has standing to

bring the derivative suit. If the nonprofit corporation seeks to reassert its right to control the litigation, the corporation will form a special litigation committee to determine if the litigation is in the best interests of the corporation. If the corporation files a motion to dismiss the litigation based upon the recommendation of the special committee, Delaware law requires the corporation to bear the burden of proving the independence of the committee, the reasonableness of its investigation, and the reasonableness of the bases of its decision reflected in the motion. *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981). *Zapata* also permits the court a discretionary second step to review the special committee's decision by invoking the court's "independent business judgment." *Id.* at 789.

In the usual scenario where demand is not excused, the member must demand that the board take action and the *Zapata* principles do not apply. The board or special committee of independent directors decides whether the nonprofit corporation should take the action the member requests or respond in some other way. As in the case of all board decisions, the board's response to the member's demand is presumptively protected by the traditional business judgment rule. *Allison v. General Motors Corp.*, 604 F. Supp. 1106, 1122 (D. Del. 1985). As a result, the member in filing suit bears the normal burden of creating by particularized pleadings a reasonable doubt that the board's response to the demand was wrongful. *Levine v. Smith*, 591 A.2d 194, 210 (Del. 1991). The plaintiff must allege with particularity a lack of good faith, care, independence, or disinterestedness by the directors in responding to the demand.

In contrast to Delaware's approach, some jurisdictions have adopted uniform tests to judge both demand-required and demand-excused situations. For example, in New York, judicial review is always limited to an analysis of the independence and good faith of the board or committee and the reasonableness of the bases for the board's decision, and the court does not have the discretionary authority to use its independent business judgment. *Auerbach v. Bennett*, 47 N.Y.2d 619, 633-34, 419 N.Y.S. 2d 920, 928-29, 393 N.E.2d 994, 1002-03 (1979). In contrast, the

North Carolina Supreme Court has interpreted that state's statutory provisions on derivative actions as requiring the application of the *Zapata* criteria in both demand-required and demand-excused cases. *Alford v. Shaw*, 358 S.E.2d 323, 327 (N.C. 1987).

Since Section 13.03 requires demand in all cases, the distinction between demand-excused and demand-required cases does not apply. Subsections (c) and (d) of Section 13.05 carry forward the distinction, however, by establishing pleading rules and allocating the burden of proof depending on whether there is a majority of independent directors. Subsection (c), like Delaware law, assigns the plaintiff the threshold burden of alleging facts establishing that a majority of the board is not independent. If there is an independent majority, the burden remains with the plaintiff to plead and establish that the requirements of Section 13.05(a) have not been met. If there is no independent majority, the burden is on the nonprofit corporation on the issues delineated in Section 13.05(a). In this case, the corporation must prove both the independence of the decision makers and the propriety of the inquiry and determination.

Subsections (c) and (d) of Section 13.05 thus follow the first *Aronson* standard in allocating the burden of proof depending on whether the majority of the board is independent. The committee decided, however, not to adopt the second *Aronson* standard for excusing demand (and thus shifting the burden to the corporation) based on whether the decision of the board that decided the challenged transaction is protected by the business judgment rule. The committee believes that the only appropriate concern in the context of derivative litigation is whether the board considering the demand has a disabling conflict. See *Starrels v. First Nat'l Bank*, 870 F.2d 1168, 1172-76 (7th Cir. 1989) (Easterbrook, J. concurring).

Thus, the burden of proving that the requirements of Section 13.05(a) have not been met will remain with the plaintiff in several situations. First, in subsection (b)(1), the burden of proof will generally remain with the plaintiff since the subsection requires a quorum of independent directors and a quorum is normally a majority. See Section 8.24. The burden will also remain with

the plaintiff if there is a majority of independent directors that appoints the committee under subsection (b)(2). Under Section 13.05(e), the burden of proof also remains with the plaintiff in the case of a determination by a panel appointed by the court.

The burden of proof will shift to the nonprofit corporation, however, where a majority of directors is not independent, and the determination is made by the group specified in subsection (b)(2). It can be argued that, if the directors making the determination under subsection (b)(2) are independent and have been delegated full responsibility for making the decision, the composition of the entire board is irrelevant. This argument is buttressed by the section's method of appointing the group specified in subsection (b)(2) since subsection (b)(2) departs from the general method of appointing committees and allows only independent directors, rather than a majority of the entire board, to appoint the committee which will make the determination. Nevertheless, despite the argument that the composition of the board is irrelevant in these circumstances, the committee adopted the provisions of subsections (b)(2) and (d) of Section 13.05 to respond to concerns of structural bias.

Finally, Section 13.05 does not authorize the court to review the reasonableness of the determination. As discussed above, the phrase in Section 13.44(a) "upon which its conclusions are based" limits judicial review to whether the determination has some support in finding of the inquiry.

3. Pleading

Section 13.05(c) sets forth a modified pleading rule to cover the typical situation where a plaintiff makes demand on the board, the board rejects that demand, and the plaintiff commences an action. In that scenario, in order to state a cause of action, subsection (c) requires the complaint to allege facts with particularity demonstrating either (1) that no majority of independent directors exists or (2) why the determination does not meet the standards in subsection (a). Discovery is available to the plaintiff only after the plaintiff has successfully stated a cause of action by making either of these two showings.

1 Principles of Corp. Governance § 1.23
Principles of Corporate Governance: Analysis and Recommendations
As Adopted and Promulgated by The American Law Institute at Washington, D.C., May 13, 1992
Current through April 2012

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Part I. Definitions

§ 1.23 Interested

Link to Case Citations

(a) A director [§ 1.13] or officer [§ 1.27] is “interested” in a transaction or conduct if either:

- (1) The director or officer, or an associate [§ 1.03] of the director or officer, is a party to the transaction or conduct;
- (2) The director or officer has a business, financial, or familial relationship with a party to the transaction or conduct, and that relationship would reasonably be expected to affect the director’s or officer’s judgment with respect to the transaction or conduct in a manner adverse to the corporation;
- (3) The director or officer, an associate of the director or officer, or a person with whom the director or officer has a business, financial, or familial relationship, has a material pecuniary interest in the transaction or conduct (other than usual and customary directors’ fees and benefits) and that interest and (if present) that relationship would reasonably be expected to affect the director’s or officer’s judgment in a manner adverse to the corporation; or
- (4) The director or officer is subject to a controlling influence by a party to the transaction or conduct or a person who has a material pecuniary interest in the transaction or conduct, and that controlling influence could reasonably be expected to affect the director’s or officer’s judgment with respect to the transaction or conduct in a manner adverse to the corporation.

(b) A shareholder is interested in a transaction or conduct if either the shareholder or, to the shareholder’s knowledge, an associate of the shareholder is a party to the transaction or conduct, or the shareholder is also an interested director or officer with respect to the same transaction or conduct.

(c) A director is interested in an action within the meaning of Part VII, Chapter 1 (The Derivative Action), but not elsewhere in these Principles, if:

- (1) The director is interested, within the meaning of Subsection (a), in the transaction or conduct that is the subject of the action, or
- (2) The director is a defendant in the action, except that the fact a director is named as a defendant does not make the director interested under this section if the complaint against the director:
 - (A) is based only on the fact that the director approved of or acquiesced in the transaction or conduct that is the subject of the action, and
 - (B) does not otherwise allege with particularity facts that, if true, raise a significant prospect that the director would be adjudged liable to the corporation or its shareholders.

2 Principles of Corp. Governance § 7.09

Principles of Corporate Governance: Analysis and Recommendations

As Adopted and Promulgated by The American Law Institute at Washington, D.C., May 13, 1992

Current through April 2012

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Part VII. Remedies

Chapter 1. The Derivative Action

§ 7.09 Procedures For Requesting Dismissal Of A Derivative Action

Link to Case Citations

(a) The following procedural standards should apply to the review and evaluation of a derivative action by the board or committee under § 7.08 (Dismissal of a Derivative Action Against Directors, Senior Executives, Controlling Persons, or Associates Based on a Motion Requesting Dismissal by the Board or a Committee) or § 7.11 (Dismissal of a Derivative Action Based Upon Action by the Shareholders):

- (1) The board or committee should be composed of two or more persons, no participating member of which was interested [§ 1.23] in the action, and should as a group be capable of objective judgment in the circumstances;
- (2) The board or committee should be assisted by counsel of its choice and such other agents as it reasonably considers necessary;
- (3) The determinations of the board or committee should be based upon a review and evaluation that was sufficiently informed to satisfy the standards applicable under § 7.10(a); and
- (4) If the board or committee determines to request dismissal of the derivative action, it shall prepare and file with the court a report or other written submission setting forth its determinations in a manner sufficient to enable the court to conduct the review required under § 7.10 (Standard of Judicial Review with Regard to a Board or Committee Motion Requesting Dismissal of a Derivative Action Under § 7.08).

(b) If the court is unwilling to grant a motion to dismiss under § 7.08 or § 7.11 because the procedures followed by the board or committee departed materially from the standards specified in § 7.09(a), the court should permit the board or committee to supplement its procedures, and make such further reports or other written submissions, as will satisfy the standards specified in § 7.09(a), unless the court decides that (i) the board or committee did not act on the basis of a good faith belief that its procedures and report were justified in the circumstances; (ii) unreasonable delay or prejudice would result; or (iii) there is no reasonable prospect that such further steps would support dismissal of the action.

Comment:

a. Comparison with existing law. Section 7.09(a) establishes four prerequisites to an objective review and evaluation that the court may normally rely upon for purposes of a motion under § 7.08: (1) a disinterested decisionmaker “capable of objective judgment in the circumstances”; (2) the assistance of counsel and other agents as may be reasonably necessary to assist the board or committee to reach an informed judgment; (3) an evaluative process that meets the standard of review applicable under § 7.10; and (4) the preparation of a report or other written submission setting forth the board's or committee's determinations in a manner sufficient to enable meaningful judicial review. These procedural elements have been emphasized by a number of cases, and decisions generally concur that a court may examine the procedures followed by a board or committee in reaching a decision to seek dismissal of a derivative action.

Section 7.09(b) recognizes that inadvertent, good faith errors need not be penalized, and therefore permits the board or committee to supplement its procedures when it has acted in good faith unless the court determines that one of the conditions

in § 7.09(b)(i)–(iii) is present. Relatively few cases have considered this issue of supplementation, but judicial discretion to permit defendants to renew a motion to dismiss a derivative action is generally recognized, particularly when the motion had earlier been denied for lack of compliance with procedural standards.

b. Implementation. Section 7.09 can be implemented by judicial decision.

c. Rationale. This Chapter prescribes a two-step test that must be satisfied before a court dismisses a derivative action under § 7.08 as adverse to the best interests of the corporation in whose name it is brought. First, a procedural test must be passed: the tests of Subsection (a)(1)–(4) must be satisfied. The most logical way to accomplish this is for the board or committee to provide a description of the procedures followed by the board or committee in order to satisfy § 7.09(a)(1)–(4) in the report or other written statement required by § 7.09(a)(4). Second, a substantive standard must be satisfied, with the court determining either that the board's or committee's determinations satisfy the standards of review set forth in § 7.10, or, in the case of a shareholder-adopted resolution, that the decision did not amount to waste under § 7.11(d). Section 7.09 addresses simply the first step; its effect is only to qualify the report or other written submission for judicial consideration, not to set the standard under which the report or written submission will be reviewed.

Section 7.09(a) is not, however, exclusive. Section 7.08(b) provides that a derivative action may be dismissed even though the standards of § 7.09 have not been fully satisfied, if the departures are “justified under the circumstances.”

d. Relationship to other corporate organs. Section 7.09 does not require that the review and evaluation that it contemplates be conducted wholly subsequent to the plaintiff's demand or the filing of the action. Nor need it be performed exclusively by one corporate organ. In particular, a committee delegated the board's authority under § 7.08 need not retrace all the steps already taken by the board or another committee at an earlier stage. For example, the board may have responded to the plaintiff's demand by engaging counsel and itself undertaking an investigation of some of the charges raised in the demand. When the action is later filed, the board may decide to delegate its authority to a committee of directors (possibly because a question has arisen whether one or more members of the board was interested in the action). Under these circumstances, there is no need to duplicate the work earlier performed, and the committee may retain the counsel who earlier served the board to advise it further. Of course, the circumstances would be different if the earlier inquiry and evaluation were conducted or guided by interested directors.

In general, if the board or committee relies upon earlier performed work or findings, it should satisfy itself as to (i) the sufficiency of the inquiry, (ii) the absence of intervening factors or developments, and (iii) the independence of those conducting the initial inquiry. If an earlier motion made by the corporation under § 7.04(a)(2) has been denied by the court, special considerations apply, because the court may have found that the earlier determination to reject demand either did not comply with the business judgment rule or was unreasonable in the circumstances. In such a context, the committee conducting the review and evaluation under § 7.09 should take care to make certain that its determinations do not rest on an inadequate or flawed informational base. In addition, the court should not delay the action if the end result will only be to place the same flawed determinations before it a second time. Still, the burden rests on the plaintiff to show bias or prove some other deficiency in work that the committee incorporates in its report or other written submission from prior corporate efforts at the demand stage. In general, apart from the special care needed in the case of a § 7.09 inquiry following an earlier failed motion under § 7.04(a)(2), § 7.09 requires only a reasonable review of work done at an earlier stage before that work is relied upon for purposes of this section. Thus, earlier prepared legal or other expert opinions may be used and need not be duplicated if the board or committee finds that they continue to be relevant and reliable.

Similarly, § 7.09 does not preclude a committee from reporting back to the board with its determinations for approval by the board as a whole, minus any members whose status as defendants in the action would impair their objectivity. (Some recent statutes have taken a contrary position and barred such an advisory use of the committee. See Reporter's Note 5.) If such an advisory procedure is used, however, all members of the board participating in a decision to approve the committee's report would have to satisfy the criteria set forth in § 7.09(a)(1). See *Greenfield v. Hamilton Oil Corp.*, 760 P.2d 664 (Colo.App.1988). Also, during the period that any committee is conducting its evaluation, care should be taken to minimize the contacts between the committee and the remainder of the board with respect to the committee's deliberations. In at least one instance such an

attempt to predispose the committee has led a court to reject a committee's decision. See *Swenson v. Thibaut*, 39 N.C.App. 77, 250 S.E.2d 279 (1978).

e. Short-form report. On occasion, derivative actions will be brought that are either plainly frivolous or otherwise clearly deficient of legal or factual merit, but which are nevertheless not easily dismissed on a motion for summary judgment. In such cases, the board might sometimes face the following dilemma: it may hope that a court would dismiss the action under § 7.08 based on a relatively short report or other written submission and a limited consideration of the action, but it may also fear that if the court were to find some procedural infirmity in this process, it would not later permit a fuller-scale evaluation of the action by the same board or committee. Based on such a fear, boards and committees might engage in unnecessary overkill, conducting lengthy studies and writing overlong reports, for fear that any procedural blemish on the evaluation process could deprive the board or committee of its ability to speak for the corporation.

Section 7.08(b) attempts to guard against this result by requiring only substantial compliance with the procedures of § 7.09 and expressly permitting even material departures if they were justified under the circumstances. Yet, there might still be a residual concern about the consequences of a material departure if the departure were later found to be unjustified and the law were that it could not be corrected. Section 7.09(b) resolves this problem by providing that any inadequacy in the board's or committee's initial evaluation will not bar the board or committee from correcting this deficiency and submitting a fuller study for purposes of § 7.08 or § 7.09, unless the board or committee did not act in good faith or the other circumstances specified in the final clauses of § 7.09(b) are present. The rationale for this position is that good faith mistakes should not be penalized and that expedited procedures should be encouraged where they are appropriate.

The practical impact of § 7.09(b) is to permit a board or committee to rely on procedures that do not technically comply with § 7.09(a), but that can be "justified under the circumstances" under § 7.08(b). Thus, in a given case, it might seem appropriate to rely on an "interested" counsel or to dispense with other experts whose advice might be deemed reasonably necessary. If the court determined that these procedures were not justified under the circumstances or that the report or other written submission submitted to it contained discrepancies or left important questions unanswered, it could still either withhold its decision on the motion to dismiss the action, pending supplementation, or deny the motion, with leave to replead it once a fuller study was conducted.

Section 7.09(b) does not mean, however, to invite deliberate delay or dilatory tactics. Before a board or committee knowingly departs from the standards of § 7.09(a), it should determine that expedited procedures are justified or that the departure is necessary for other reasons. The reviewing court should also consider both the possibility of prejudice to the plaintiff from the delay incident to a recommittal to the board or committee and whether a reasonable prospect exists that further steps or procedures would support termination. To be sure, it is difficult for a court to predict the likely effect of steps or procedures to be taken in the future, but the burden is placed on the plaintiff to show why the court should not permit supplementation. At this stage, the court may set time limits and structure further inquiry so that the evaluation process does not drag on unnecessarily. When an earlier motion has been unsuccessfully made under § 7.04(a)(2), such time limits may be particularly appropriate in order to prevent unnecessary delay.

Precedent supports the supplementing procedure contemplated by § 7.09(b). In *Watts v. Des Moines Register and Tribune*, 525 F.Supp. 1311 (S.D.Iowa 1981), the trial court was satisfied as to independence of the committee and the adequacy of the procedures it followed, but still found that certain inconsistencies in the record precluded dismissal of the action. Thus, it ordered a "further development of the record with regard to the committee's determinations." *Id.* This is the position taken by §§ 7.08 and 7.09: namely, that the court may allow the corporation an additional period to correct any deficiencies. See also *Abella v. Universal Leaf Tobacco Co., Inc.*, 546 F.Supp. 795, 797 (E.D.Va.1982) (court has discretion to allow the corporation to renew its motion for dismissal).

f. Use of "expansion" directors. A few decisions—most notably, *Miller v. Register & Tribune Syndicate Inc.*, 336 N.W.2d 709 (Iowa 1983)—have held that when all, or nearly all, the directors are named as defendants, the board cannot create a litigation committee by expanding its ranks and appointing the newly added directors to the committee. Section 7.09 does not adopt this sweeping a rule, which could prevent the corporation from advancing legitimate justifications for dismissal. Nevertheless, the

court should consider any relevant evidence relating to the selection of a committee appointed to consider demand or a litigation committee, including the participation of the actual or prospective defendants (other than nominal ones) in that process. If this participation was unnecessary, because other disinterested directors were available, the fact of such involvement should weigh heavily against acceptance of the report. But, when disinterested directors are not available to appoint the committee, then necessity justifies the involvement of the interested director, at least when the panel option discussed in § 7.12 is foreclosed or its availability is uncertain. This doctrine of necessity is a limited one. If quorum requirements necessitate the vote of interested directors, they should limit their participation to voting to ratify the choice of the other directors. In cases where all or a substantial majority of the board are interested, the optimal procedure would be an application for the appointment by the court of a special panel under § 7.12 (Special Panel or Special Committee Members).

g. Committee composition. Section 7.09(a) requires that a litigation committee or a committee appointed to consider a demand be composed of two or more directors. Although three directors has been the more common practice, decisions have upheld the use of a litigation committee of two. See Reporter's Note 2. Use of a single individual is, however, disapproved, partly because of the importance of collegial interchange and deliberation. Some cases have also expressed doubt about the ability of a single individual to withstand pressure under these circumstances.

Section 7.09 requires, first, that the committee members not be "interested," as this term is defined in § 1.23, and, second, that the committee "as a group be capable of objective judgment in the circumstances." This latter provision has a dual significance: First, it requires that the committee be able to understand and evaluate the transaction at issue. The absence of a disabling conflict of interest alone is insufficient; some affirmative capacity to judge the issues in dispute is necessary. Second, although the definition of "interested" looks only to economic and familial associations, the requirement of a capacity for "objective judgment" invites the court to look to other relationships that may also bias the inquiry. For example, a director who was the close personal friend and next-door neighbor of the defendant would probably lack this capacity and should not serve on the committee. See Reporter's Note 6.

A difficult issue surrounds the question whether a director who is named as a defendant in the action must always be considered "interested" and hence disqualified from serving. Cases have recognized that mere acquiescence in, or approval of, the challenged transaction should not alone disqualify a board member. See *Lewis v. Graves*, 701 F.2d 245 (2d Cir.1983). Thus, § 1.23(c) adopts a special definition of "interested" for purposes of this Chapter in order to allow directors who are only in effect nominal defendants to serve on a committee or to participate in the full board's deliberations for purposes of approving board or committee action with respect to a derivative action. Although it is recognized that any director who has been sued will have a natural desire to secure the early termination of even a meritorious case, a broader rule that automatically disqualified such a director whenever the director was named as a defendant would create an incentive for the plaintiff to sue all the incumbent directors in order to disqualify them. Under § 1.23(c), a director is not "interested" if liability is asserted against the director "based only on the fact that the director approved of or acquiesced in the transaction or conduct that is the subject of the action" and the complaint "does not otherwise allege with particularity facts that, if true, raise a significant prospect that the director would be adjudged liable to the corporation or its shareholders." In effect, § 1.23(c) supplies a definition of the nominal defendant who should not be disqualified from serving on a committee based simply on plaintiff's creative manipulation of the pleadings. Operationally, the trial court could determine that there was no significant prospect of liability against such a defendant in much the same way as it would pass on a motion for summary judgment. If certainty is desired, the corporation could bring an early motion for a declaratory judgment that a specific director was not "interested" and thus could serve on a committee or participate on the board for purposes of § 7.09.

h. Counsel. The role of counsel is especially sensitive in internal corporate evaluations of the type dealt with in § 7.09. Accordingly, § 7.09(a)(2) specifies that the board or committee should select a counsel of its choice to coordinate and advise such an inquiry. Case law has also placed considerable weight on the objectivity and ability of the special counsel retained by the committee. At least one decision has rejected the report of a special litigation committee in part because the committee failed to engage such a special counsel. See *Grynberg v. Farmer*, Fed. Sec. L. Rep. (CCH) ¶ 97,683, at p. 98,584 (D.Colo.1980). See also cases cited at Reporter's Notes 3 and 4.

Section 7.09(a)(2) does not require that the counsel who assists the board or committee be “independent” of the corporation and thus it does not preclude house counsel from serving the board or committee in some circumstances. However, it assumes that such counsel must be capable of exercising independent professional judgment under the circumstances. Thus, whether the corporation's house counsel could advise the board or committee with respect to the conduct of corporate officers depends in the first instance on whether the counsel was in a subordinate or reporting position to those officers. If a counsel is in such a position, then the logic of § 1.23(a)(4), which deems “interested” a person subject to a “controlling influence,” strongly suggests that an in-house counsel would not be in a position to exercise independent professional judgment with respect to the liability of a direct superior. Similarly, the corporation's principal outside corporate or securities counsel may also be disabled on these facts.

Conversely, if the action were against an outside director or a corporate official below the general counsel's rank or position in the corporation, the general counsel or the corporation's regular outside counsel could serve the board or committee. In all cases, however, the committee or board should be free to make its own choice of counsel and should not allow this selection to be imposed upon it by others.

i. Adequate evaluation. Section 7.09 does not specify the precise procedures the committee should follow in reaching an “evaluation that was sufficiently informed to satisfy the standards applicable under § 7.10(a).” In some cases, a relatively abbreviated process will demonstrate that the allegations are plainly frivolous and without support. In other cases, the committee will need to conduct detailed interviews with relevant witnesses and should preserve a record of such oral evidence. Affidavits or sworn depositions may also be desirable in many instances, particularly when dealing with corporate employees or agents who can be required to cooperate. Although reliance on the unsworn testimony of persons interested in a lawsuit seems generally ill-advised, sworn testimony is not a necessary element of § 7.09's procedures because it would be impractical in some cases and might chill the willingness to be interviewed of third parties not subject to the corporation's authority. However, the court should consider the justifications for dispensing with such testimony. In general, the nature of the inquiry that is required under § 7.09(a)(1) depends on all of the circumstances, including such factors as the gravity and plausibility of the complaint, the detail with which the claims are alleged, and the underlying nature of the claim. Where the gravamen of a complaint concerns a claim that would be reviewed under the business judgment rule in the absence of a board or committee recommendation, the inquiry by the board or committee should be that which would be necessary to satisfy the informational component of that rule, and the board or committee should inform itself in a manner sufficient to satisfy that rule. See § 4.01(c)(2). If the gravamen of a complaint concerns a claim that would be reviewed under a more exacting standard than the business judgment rule in the absence of a board or committee recommendation, the inquiry may have to be more substantial to satisfy the standards of § 7.10(a).

In all cases in which the board delegates authority to a committee, the committee should have unrestricted access to all corporate records, memoranda, files, correspondence, and witnesses that it deems relevant for purposes of its inquiry. No other person should define the limits of relevancy for the committee or its counsel. The cooperation of corporate officials in making available employees (who may often be located at remote or even foreign sites) is also essential to an adequate investigation on which a court may reasonably rely.

Although termination of a derivative action may ultimately be justified even when the action is factually and legally well-founded, the committee should evaluate the factual and legal basis of the action before determining that dismissal is justified, even when the basis for dismissal rests on extrinsic business justifications. However, when a request for injunctive relief constrains the time available for inquiry and the status quo cannot be otherwise preserved, this evaluative process might properly be an abbreviated one.

The board's or committee's review and evaluation necessarily have a broader scope than those which the court must undertake in evaluating its report or other written submission. Under § 7.10, the court need not resolve all contested factual issues. The board or committee must, however, satisfy itself as to the action's factual and legal merit and not simply compute the cost and delay to which the action will subject the corporation. Although not all factual issues can be resolved, a reasonable effort to establish the relevant facts is required.

That degree of confidentiality should surround the board's or committee's proceedings as is necessary to assure the integrity of its evaluative process. Section 7.09 does not attempt to formulate precise rules in this regard, and certainly does not bar reports to the board by the committee or confrontation of the principal defendants with the charges raised against them. Still, in general, disclosure of confidential information, particularly that derived from witnesses appearing before the board or committee, should be restricted on a "need to know" basis.

REPORTER'S NOTE

1. Most of the decisions that have rejected a litigation committee's motion to dismiss have identified inadequacies in the procedures followed or in the independence of the participating directors. See *Swenson v. Thibaut*, 39 N.C.App. 77, 250 S.E.2d 279 (1978); *Hasan v. CleveTrust Realty Investors*, 729 F.2d 372 (6th Cir.1984); *Miller v. Register & Tribune Syndicate, Inc.*, 336 N.W.2d 709 (Iowa 1983); *Holmstrom v. Coastal Ind., Inc.*, 645 F.Supp. 963 (N.D. Ohio 1984). Two other cases have declined to accept a committee's recommendation for dismissal pending a fuller explanation of its reasons for seeking termination: *Maldonado v. Flynn*, 671 F.2d 729 (2d Cir.1982), and *Watts v. Des Moines Register & Tribune*, 525 F.Supp. 1311 (S.D.Iowa 1981). In *Swenson*, it was deemed significant that the board had not delegated its full authority to the committee, but had only made an advisory referral. In *Holmstrom*, the court found the report inadequate because it was "devoid of factual findings to support the conclusions reached." It added:

The summary treatment of the issue of self-dealing and the use of the power as directors to perpetuate their self-control negate the possibility of judicial approval of the work of the [committee].

645 F.Supp. at 972. In *Hasan*, a single director served as the litigation committee, and the Circuit Court found his prior relationship to the defendant to have been sufficiently close to bar reliance on his findings, even though it is not clear whether he would have been "interested" within the meaning of § 1.23(c).

2. Although three-member committees have been more common, a number of decisions and a Minnesota statute have expressly approved two-member committees. See Minn. Bus. Corp. Act § 302 (1981) (two or more members); *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del.1981); *Mills v. Esmark, Inc.*, 573 F.Supp. 169 (N.D.Ill.1983); *Abella v. Universal Leaf Tobacco Co.*, 546 F.Supp. 795 (E.D.Va.1982). In *Hasan v. CleveTrust Realty Investors*, 729 F.2d 372, 378-80 (6th Cir.1984), the lower court had approved a one-member committee when the other eight members of the board had been named as defendants. However, this result was reversed on appeal because the committee member had been a minority investor in a real estate venture with one of the principal defendants (one being a 10% partner; the other, a 2% partner) and had had other business dealings in past years with him. See also *Lewis v. Fuqua*, 502 A.2d 962, 967 (Del.Ch.1985). ("If a single member committee is to be used, the member should, like Caesar's wife, be above reproach."); *Houle v. Low*, 407 Mass. 810, 556 N.E.2d 51, 59 (1990) ("number of committee members should be a factor in determining the committee's ability to act independently"). Under the Indiana statute, the committee must have at least three members. See Ind. Code Ann. § 23-2-32-4.

3. Recent decisions have also required that a litigation committee "conduct a thorough and careful analysis regarding the plaintiff's derivative suit." *Houle v. Low*, 407 Mass. 810, 556 N.E.2d 51, 58 (1990); *Davidowitz v. Edelman*, 153 Misc.2d 853, 583 N.Y.S.2d 340 (N.Y.Sup.1992) (committee's investigation rejected when it "did not fulfill the requirements of a thorough and reasonable inquiry"). Even though the court's own substantive power of review was limited under New York law, the *Davidowitz* court emphasized that it remained the committee's obligation to satisfy "the careful, diligent and meticulous standard required of a committee scrutinizing a possible breach of fiduciary duty." When this standard was not complied with, such a failure "vitiates the usefulness of the committee's findings as a defense to the action." *Id.* at 344.

4. Judicial review of the procedures by which a board committee conducts its evaluation of the plaintiff's allegations has focused in particular on the interaction between the board and its special counsel. Some decisions have criticized excessive reliance on such counsel. See *Rosengarten v. International Telephone & Telegraph Corp.*, 466 F.Supp. 817, 824-25 (S.D.N.Y.1979). In rejecting the committee's determinations in *Davidowitz v. Edelman*, *supra*, the New York Supreme

Court emphasized that the corporation's general counsel had selected the attorney for the committee and that "the committee did not join in their counsel's investigation or review, save in the most perfunctory manner ..." Id. at 344. See also *Peller v. Southern Co.*, 911 F.2d 1532, 1538 (11th Cir.1990) (rejecting committee's report when committee relied almost exclusively on its special counsel to conduct the substance of the investigation). Decisions have also placed substantial weight on the independence and legal ability of the special counsel retained by the committee. For example, in *In re Par Pharmaceutical, Inc. Derivative Litigation*, 750 F.Supp. 641 (S.D.N.Y.1990), the failure to appoint such a counsel was one of the salient facts relied upon by the court in failing to dismiss the action. See also *Lasker v. Burks*, 426 F.Supp. 844, 850 (S.D.N.Y.1977); *Auerbach v. Bennett*, 47 N.Y.2d 619, 635, 419 N.Y.S.2d 920, 929, 393 N.E.2d 994, 1003 (1979); *Grynberg v. Farmer*, Fed. Sec. L. Rep. (CCH) ¶ 97,683, at 98,586 (D.Colo.1980) (decision rejected when committee failed to retain independent counsel). One statute has adopted a more severe test of independence for a counsel in another context. See Ohio Rev. Code Ann. § 1701.13(E)(4)(C) (1979) (disqualifying any attorney who previously served the corporation over the prior five years from delivering an opinion on which indemnification can be awarded).

5. Courts have also placed considerable weight on the extent of the power delegated to the full board by the committee. Where the committee has only advisory authority, rather than being vested with the board's full plenary authority, its independence has been found inadequate by some courts. See *Swenson v. Thibaut*, 39 N.C.App. 77, 250 S.E.2d 279, 297-98 (1978); *Greenfield v. Hamilton Oil Corp.*, 760 P.2d 664 (Colo.App.1988). Midstream changes in the committee's composition or authority, or the scope of the investigation it was charged to make, have also produced judicial rejection of the committee's determinations. See *Reilly Mortg. Group v. Mount Vernon Savings & Loan Ass'n*, 568 F.Supp. 1067, 1072 (E.D.Va.1983). Recent statutory provisions authorizing the use of litigation committees have placed limitations on their composition and performance that do not apply to other board committees. For example, under the Minnesota statute, a committee member may not own more than one percent of the corporation's stock, may not be a present or former officer, employee, or agent of the corporation or any related corporation, and may not be a party to the action or a person who has been threatened with being named as such a party. See Minn. Stat. § 302A.243. Once a committee is appointed, it may not be suspended, terminated, or instructed by the board as to its findings; its determination binds the corporation and its directors, officers, and shareholders. In short, the committee cannot be confined to an advisory role.

Under the Virginia statute, the committee directly reports its findings to the court. See Va. Code § 13.1-673(D). This seemingly bars the use of such a litigation committee as an advisory body to the board, and implies that no other procedure is acceptable.

6. Section 7.09's requirement that committee members "should as a group be capable of objective judgment in the circumstances" is supported by *Lewis v. Fuqua*, 502 A.2d 962 (Del.Ch.1985). There, the principal defendant had been a major donor to a university whose president was selected as the one-person litigation committee that reviewed the pending action. Although no continuing economic relationship between the two individuals or specific bias was shown, the Delaware Chancery Court found that there had been a long association between the two individuals. It therefore declined to find that the litigation committee was independent, and, in so doing, specified a high standard for independence:

The only instance in American Jurisprudence where a defendant can free itself from a suit by merely appointing a committee to review the allegations of the complaint is in the context of a stockholder derivative suit. A defendant who desires to avail itself of this unique power to self-destruct a suit brought against it ought to make certain that its Special Litigation Committee is truly independent.

Similarly, in *Davidowitz v. Edelman*, 153 Misc.2d 853, 583 N.Y.S.2d 340 (N.Y.Sup.1992), the court found that the chairman of the "special litigation committee was the president of a college to whom the principal defendant (the corporation's CEO) had recently donated \$1.5 million; in addition, the committee chairman had participated with the CEO's investment group in prior takeovers and takeover attempts engineered by the CEO. Another committee member was the CEO's personal tax attorney. On this basis, the court concluded:

The close business and personal relations demonstrated among the committee members, the board and [the CEO] preclude this court from finding that the committee possessed the required disinterested independence...."

Id. at 343.

7. New York decisions have generally required that committee members not stand “in a dual relation which prevents an unprejudicial exercise of judgment.” *Auerbach v. Bennett*, 47 N.Y.2d 619, 631, 419 N.Y.S.2d 920, 927, 393 N.E.2d 994, 1001 (1979); *Parkoff v. General Telephone & Electronics Corp.*, 53 N.Y.2d 412, 417, 442 N.Y.S.2d 432, 425 N.E.2d 820 (1981). While *Davidowitz* suggests that reciprocal directorships may offend this standard, other decisions have been less restrictive. In *Rosengarten v. Buckley*, 613 F.Supp. 1493 (D.Md.1985), the court accepted a committee's recommendation to dismiss when one committee member was the chief executive officer of another corporation of which a principal defendant was also a director. The court rejected the theory that this relationship of reciprocal board membership gave the defendant control over the committee member's salary. In *Genzer v. Cunningham*, 498 F.Supp. 682 (E.D.Mich.1980), a paid consultant to the corporation was found to be independent for purposes of litigation committee membership, and in *In re General Tire & Rubber Co. Sec. Litigation*, 726 F.2d 1075, 1084 (6th Cir.1984), the committee was found to be independent even though one member was a partner in a law firm retained by the corporation who had performed prior investigative services for the corporation. Although the decision in *Rosengarten* seems correct on its facts, both *Genzer* and *General Tire* involve more questionably entangling prior relationships. It would be a close question of fact in such cases whether these individuals qualified under § 7.09(a)(1)'s test of “capable of objective judgment in the circumstances.” For decisions holding that purely nominal defendants may serve on a litigation committee, see *Mills v. Esmark, Inc.*, 544 F.Supp. 1275, 1283 (N.D.Ill.1982); *Klotz v. Consolidated Edison Co. of New York, Inc.*, 386 F.Supp. 577, 580–82 (S.D.N.Y.1974); *In re General Tire & Rubber Co. Securities Litigation*, 726 F.2d 1075 (6th Cir.1984). But see *Galef v. Alexander*, 615 F.2d 51, 61 (2d Cir.1980) (“[W]here the directors, themselves, are subject to personal liability in the action, [they] *cannot* be expected to determine impartially whether it is warranted.” (quoting *Abbey v. Control Data Corp.*, 603 F.2d 724, 727 (8th Cir.1979), cert. denied, 444 U.S. 1017, 100 S.Ct. 670, 62 L.Ed.2d 647 (1980)) (emphasis only in *Galef*)).

Research References

1. Digest System Key Numbers

Corporations ☞ 206(1), 299; Pretrial Procedure ☞ 551, 644, 675.

2. A.L.R. Annotation

Propriety of termination of properly initiated derivative action by “independent committee” appointed by board of directors whose actions (or inaction) are under attack. 22 ALR4th 1206.

Case Citations

Case Citations through June 2011

Case Citations through June 2011:

D.Md.1985. § 7.03 (T.D. No. 1, 1982) cit. in case cit. in disc. § 7.03(b) is now under § 7.09; § 7.10, com. (d) (Discussion Draft No. 1, 1985) quot. in sup. § 7.10, com. (d) is now § 7.09, com. (f). Stockholders brought a derivative suit against the corporation, alleging that corporation's purchase of stock in a foreign company was a waste of corporate assets. The corporation's board of directors formed an independent committee to evaluate the suit. This court granted defendant's motion to dismiss, holding that the committee's composition, investigation, and conclusions passed muster under the pertinent nationwide majority rule, which permitted an interested board of directors to appoint a special litigation committee of independent directors to review a pending derivative suit. The court reasoned that Maryland did not have statutory provisions similar to states that favored suits by minority shareholders. It also stated that one shareholder should not be able to incapacitate an entire board merely by leveling charges against it. *Rosengarten v. Buckley*, 613 F.Supp. 1493, 1498, 1499.

E.D.Pa.2003. Subsec. (a) cit. and quot. but dist. Minority shareholders of mortgage company created through merger brought derivative action against acquiring bank and bank's officers and directors, alleging, inter alia, that defendants interfered

with prospective economic advantage and breached fiduciary duty to mortgage company by frustrating sale of company's assets. District court, *inter alia*, granted defendants' motion for summary judgment, holding that business-judgment rule shielded individual defendants from liability for not pursuing derivative action on company's behalf based on independent investigator's determination that shareholders had no viable claim, notwithstanding that investigator was hired by interested directors who adopted his report. *Powell v. First Republic Bank*, 274 F.Supp.2d 660, 669.

Colo.App.1988. *Cit. in disc., coms. cit. generally in disc.* (citing § 7.10, T.D. No. 8, 1988, which is now covered under § 7.09 of the official text). Shareholders brought a derivative action against a corporation after an outside corporation acquired a block of the corporation's capital stock from its president. Plaintiffs asserted that the acquisition agreement constituted a sale of corporation's assets, which president siphoned off for personal gain, in violation of his duty to corporation. They also asserted that corporation's board violated duty of loyalty by taking position of neutrality concerning acquisition offer. Trial court dismissed claims because corporation's special litigation committee determined that claims lacked merit. Reversing and remanding, this court held that, even assuming that Colorado would adopt the special litigation committee rule and that the committee members met the fairness and impartiality tests, defendants could not obtain dismissal because the ultimate decision to dismiss was made by those persons who, as defendants in the litigation, had a vital personal interest in the decision. *Greenfield v. Hamilton Oil Corp.*, 760 P.2d 664, 667, 668.

Iowa, 1983. *Cit. in sup., cit. in spec. conc. op.* (citing § 7.03(b), (c), and (e), T.D. No. 1, 1982, which is now covered under §§ 7.08–7.10 of the official text). Shareholder brought federal court derivative action on behalf of corporation alleging that it had sold its stock at fraudulently low prices and for grossly inadequate consideration to key employees. All four members of corporation's board of directors were named as individual defendants. After board subsequently expanded to six members, it established an independent litigation committee to investigate shareholder's derivative action. Pursuant to committee's conclusion that there was no justification to pursue derivative action, corporation filed motion for summary judgment. Answering federal court's certified question in the negative, this court held that corporate directors who were parties to a derivative action could not confer upon a special committee the power to bind corporation as to its conduct of the litigation. Special concurrence argued that litigation committee device was unavailable because the four directors had controlling influence over corporation's management and engaged in self-dealing. *Miller v. Register and Tribune Syndicate, Inc.*, 336 N.W.2d 709, 717–719.

Mass.1990. *Cit. in disc.* § 7.10 (T.D. No. 9, 1989), which is now covered under § 7.09 of the official text. Ophthalmologist who formed corporation with other ophthalmologists sued, individually and derivatively as a minority shareholder, the corporation, the other ophthalmologists, and two affiliated corporations, alleging fraud, breach of fiduciary duty, and misappropriation of corporate opportunities. Nondefendant director and shareholder of corporation, who was appointed by corporation's directors to serve as a special litigation committee, recommended that no action be taken on plaintiff's derivative claims. Trial court entered summary judgment for defendants. Affirming in part, reversing in part, and remanding, this court held, *inter alia*, that the special litigation committee device was permissible under Massachusetts law, and that trial judge, on remand, must determine whether committee was independent and unbiased, and whether committee reached a reasonable and principled decision. While declining to adopt a *per se* rule that special litigation committees should have more than one director, the court noted that the number of committee members should be a factor in determining committee's ability to act independently. *Houle v. Low*, 407 Mass. 810, 556 N.E.2d 51, 56, 59.

Pa.1997. *Cit. generally in synopsis and in headnote, quot. in appendix, cit. in sup., cit. in sup. and adopted* §§ 7.02–7.10 and § 7.13. In minority shareholders' derivative actions, a corporation moved for summary judgment, seeking termination of the lawsuits. After the trial court denied the corporation's motion, this court granted the corporation's petition for extraordinary relief. Reversing the trial court's order and remanding, this court held that the business judgment rule applied in Pennsylvania and permitted the board of directors of a Pennsylvania corporation to terminate derivative lawsuits brought by minority shareholders. The court adopted §§ 7.02–7.10 and § 7.13 of the American Law Institute's Principles of Corporate Governance with respect to the determination of whether the board's decision to reject or terminate litigation by or on behalf of the corporation was properly made and thus whether the business judgment rule protected the board's decision. *Cuker v. Mikalauskas*, 547 Pa. 600, 692 A.2d 1042, 1043, 1049, 1053.

Pa.Super.2008. Cit. in sup., adopted in case cit. in sup. §§ 7.07–7.10; cit. in sup., subsecs. (a) and (a)(2) and com. (f) quot. in sup., com. (g) quot. in disc. Minority shareholders filed a derivative action against controlling officers, shareholders, and company, alleging that members of a special litigation committee, formed to determine whether prosecution of certain self-dealing claims brought against controlling shareholders would be in the best interest of the company, breached their fiduciary duties in investigating those claims. The trial court sustained defendants' preliminary objections and granted their motion to dismiss the derivative suit with prejudice. Affirming, this court held, *inter alia*, that the trial court did not abuse its discretion in determining, based largely on guidelines for judicial review as set forth in the American Law Institute's Principles of Corporate Governance, that the committee's decision to seek dismissal of the derivative suit was entitled to protection under the business-judgment rule; the committee was properly formed, independent, disinterested, and adequately informed, conducted an investigation that was adequate in scope, properly used assistance of outside counsel, acted in good faith, and produced an extensive report that facilitated court review. *Lemenestrel v. Warden*, 964 A.2d 902, 904, 912–914, 921.

Tenn.App.1992. Subsec. (a) cit. in disc. (citing § 7.10, T.D. No. 8, 1988, which is now covered under § 7.09 of the official text). Former bank president filed a shareholder's derivative action, alleging mismanagement and self-dealing by several bank directors and officers of bank whose chairman of the board of directors effectively controlled more than one-half of bank's stock. This court affirmed the trial court's dismissal, holding that it had no basis on which to find that the one-person special litigation committee appointed to review plaintiff's allegations and to determine whether maintaining the suit was in the bank's best interest failed to exercise sound business judgment when it determined that the derivative complaint should be dismissed. *Lewis v. Boyd*, 838 S.W.2d 215, 223.

(1994)

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Tab C

235 Wis.2d 646

Editor's Note: Additions are indicated by Text and deletions by Text .

Supreme Court of Wisconsin.

Stephen EINHORN, Plaintiff-Appellant-Petitioner,
v.

James D. CULEA, Northern Labs, Inc. and Northern
Labs Manufacturing, Inc., Defendants-Respondents.

No. 97-3592. | Argued Jan. 5,
2000. | Decided June 22, 2000.

Minority shareholder brought direct action against majority shareholder who received retroactive bonus, alleging breach of fiduciary duty. After requiring minority shareholder to bring derivative action and special litigation committee determined derivative action was not in corporation's best interest, the Circuit Court, Ozaukee County, Joseph D. McCormack, J., dismissed action based on committee's recommendation, and minority shareholder appealed. The Court of Appeals affirmed, 591 N.W.2d 908, and review was granted. The Supreme Court, Shirley S. Abrahamson, Chief Justice, held that: (1) addressing an issue of first impression, objective test, considering totality of the circumstances, applied in determining whether committee members were independent, and (2) evidence raised significant questions concerning whether committee members were independent, requiring remand for sufficient findings of fact and application of proper legal standard.

Reversed and remanded.

Attorneys and Law Firms

****80 *648** For the plaintiff-appellant-petitioner, there were briefs by Robert H. Frieber, Matthew W. O'Neill and Frieber, Finerty & St. John, S.C., Milwaukee, and oral argument by Matthew W. O'Neill.

For the defendants-respondents, there was a brief by Dean P. Laing and O'Neil, Cannon & Hollman, S.C., Milwaukee, and oral argument by Dean P. Laing.

Opinion

¶ 1 SHIRLEY S. ABRAHAMSON, Chief Justice.

This is a review of a published decision of the court of appeals¹ affirming a judgment and order of the circuit court for Ozaukee County, Joseph D. McCormack, Circuit Judge. The circuit court dismissed the derivative shareholder action of Stephen Einhorn, a minority shareholder and member of the board of directors of Northern Labs.² The circuit court concluded that the threshold for determining whether a member of the special litigation committee is independent within the meaning of Wis. Stat. § 180.0744 (1997-98) is "extremely low" and found that the special litigation committee was independent. Accordingly, the circuit court dismissed Einhorn's derivative action pursuant to § 180.0744(1).³

****81 *649** ¶ 2 The court of appeals affirmed the judgment of the circuit court, concluding that the circuit court's assessment of whether each member of the special litigation committee was independent was based on facts supported by the record and was not clearly erroneous.

¶ 3 The issue raised in the present case is the proper interpretation and application of the standard set forth in Wis. Stat. § 180.0744 of whether a member of a special litigation committee is independent. The issue is not whether the derivative action will succeed, but whether the derivative action should be dismissed on the basis of the decision of the special litigation committee.⁴ For the reasons set forth, we conclude that the circuit court and the court of appeals erred in declaring that the threshold established by the legislature in § 180.0744 in determining whether a member of a special litigation committee is independent is "extremely low." We further conclude that in deciding whether members of the special litigation committee are independent, the circuit court should determine whether, considering the totality of the circumstances, a reasonable person in the position of the member of the special litigation committee can base his or her decision on the merits of the issue rather than on extraneous considerations or influences. In other words, the ***650** test is whether a member of the committee has a relationship with an individual defendant or the corporation that would reasonably be expected to affect the member's judgment with respect to the litigation at issue. Because the circuit court did not make sufficient findings of fact and did not apply the correct legal standard to determine whether the members of the special litigation committee were independent, we reverse the decision of the court of appeals and remand the cause to the circuit court for further proceedings not inconsistent with this decision.

I

¶ 4 We set forth the background of the dispute here. Additional facts relevant to the issue of whether the members of the special litigation committee were independent are set forth later in the opinion.

¶ 5 In December 1985, James D. Culea (the defendant), Stephen Einhorn (the plaintiff), and Einhorn's business partner, Orville Mertz, acquired Northern Labs. The Northern Labs stock was distributed as follows: Culea 56.09%, Einhorn 20.60% and Mertz 20.06%.⁵ The remaining stock was owned by other managers and directors. Culea has served as president, manager, director and majority shareholder of Northern Labs since 1986. Einhorn has been a director and minority shareholder.

¶ 6 At the time of its acquisition in 1985, Northern Labs had annual sales of \$16 million and generated little profit. During the period between 1986 and 1992, Northern Labs' sales and profits increased. In the 1993 *651 fiscal year, Northern Labs generated \$33 million in sales and \$1.9 million in profits.

¶ 7 In 1992, Culea sought a retroactive performance bonus, asserting that he had been undercompensated in the years following **82 the acquisition. In May 1992, he sent a notice to the directors scheduling a compensation committee meeting and a board of directors meeting for July 29, 1992. At that time the board of directors consisted of Culea, his wife Shelly Culea, Einhorn, Mertz, and the company's vice president of finance, Robert Bonk. Culea, Mertz and Bonk comprised the compensation committee.

¶ 8 On July 29, 1992, the compensation committee unanimously approved a retroactive bonus to Culea of approximately \$300,000, a portion of which was to be paid with Northern Labs stock. A board of directors meeting was held immediately after the compensation committee meeting. The four directors in attendance - Culea, Mertz, Bonk and Shelly Culea - voted unanimously to ratify the compensation committee's decisions. Einhorn did not attend the July 29, 1992, board of directors meeting. Following Culea's stock compensation, the stock was allocated as follows: Culea 76%, Einhorn 22%, and Bonk 2%.⁶

¶ 9 On December 9, 1993, Einhorn filed a direct action against Culea, alleging that Culea had willfully breached his fiduciary duty to Einhorn by participating in and causing the

corporation to award a self-dealing retroactive bonus to Culea of \$300,000 and to issue stock for no consideration or at a grossly inadequate price. Einhorn alleged that he had been "damaged by the dilution of his percentage of ownership in the companies and by a reduction in the value of his interest in *652 the companies...." Einhorn sought a judgment ordering Culea to surrender stock to Northern Labs and to reimburse Northern Labs for all cash payments received by him for the retroactive bonus.

¶ 10 On May 3, 1994, Culea filed a motion for summary judgment arguing, among other things, that Einhorn improperly filed his suit as a direct action instead of a derivative action. The circuit court agreed with Culea and gave Einhorn 30 days to amend his complaint.

¶ 11 Einhorn amended his complaint in November 1994 to state a derivative action with allegations similar to those in his original complaint. The members of the board of directors in November 1994 were, pursuant to a stock agreement, appointees of Culea and Einhorn. In addition to himself and his wife, Culea appointed his neighbor Dwight Chewning, Northern Labs CFO Robert Bonk, and Lolita Chua, a friend of Shelly Culea. Einhorn appointed himself and his business partner, John Beagle.

¶ 12 Following Einhorn's amended complaint, on December 9, 1994, Culea issued a notice of a special meeting of the board of directors for December 16, 1994. Culea's notice indicated that Chewning and Chua were new members of the board and that the board would be voting on whether the maintenance of Einhorn's derivative action was in the best interests of the corporation. Einhorn requested to bring an attorney to the meeting but his request was denied by the corporate counsel for Northern Labs. Corporate counsel's firm represented Culea in the action filed by Einhorn.

¶ 13 The board of directors met as scheduled on December 16, 1994. Northern Labs' corporate counsel advised that because Einhorn, Culea and Shelly Culea *653 had an interest in the dispute, they should not participate in any vote, whether as directors or as potential members of any special litigation committee. The board then created a special litigation committee composed of Chewning, Bonk, Chua and Beagle.⁷

**83 ¶ 14 After five months of meetings and approximately 500 hours of inquiry, the special litigation committee voted three to one that continuation of Einhorn's derivative action was not in the best interests of the corporation.⁸ Based on this

vote and pursuant to Wis. Stat. § 180.0744(1), Culea moved the circuit court to dismiss Einhorn's derivative action.

¶ 15 In a decision and order dated October 30, 1995, the circuit court denied Culea's motion to dismiss the action, stating that it was not prepared to find that the special litigation committee met the criteria of being independent set forth in Wis. Stat. § 180.0744. After a seven-day trial to the circuit court on the issue of whether the members of the special litigation committee were independent under § 180.0744, the circuit court concluded that the threshold established by the *654 legislature in determining whether members of the special litigation committee were independent is "extremely low." The circuit court found that the members of the committee were independent within the meaning of § 180.0744, that they acted in good faith and that they made their determination from conclusions based upon a reasonable inquiry.⁹ The circuit court dismissed the derivative action. The court of appeals affirmed the judgment of the circuit court.

II

[1] ¶ 16 The present case is a derivative action. A derivative action differs from ordinary commercial litigation and from a representative action such as a class action. In a derivative action, the claims belong to the corporation, not to the complaining shareholder. The complaining shareholder is challenging, on behalf of the corporation that has been unwilling to bring the suit, specific corporate conduct.¹⁰

[2] *655 ¶ 17 A derivative action reflects competing interests: On the one hand, the action allows shareholders to assert the corporation's rights when corporate management refuses to do so. On the other hand, the board of directors or majority shareholders of a corporation, not the courts or minority shareholders, should resolve internal conflicts. A derivative action raises the specter of undue judicial interference with the business judgment of corporate management. In other words, a derivative action is a means to curb managerial misconduct, yet it also undermines the basic principle of corporate governance that the decisions of a corporation, including the decision to initiate litigation, should be made by the board of directors.

¶ 18 Courts and legislatures have allowed corporations to use special litigation committees to dismiss derivative actions in an attempt to balance the competing interests at issue: the shareholders' need to protect the corporation and the corporation's need to prevent meritless or harmful *84

litigation.¹¹ If the special litigation committee is independent from the alleged wrongdoers, acts in good faith and conducts a reasonable inquiry upon which its conclusion is based, the committee's recommendation not to proceed with a derivative action is viewed as a proper exercise of the directors' business judgment and the court will dismiss the action.¹²

[3] [4] *656 ¶ 19 The concept of the special litigation oversight committee flows from the business judgment rule, a judicially created doctrine that limits judicial review of corporate decision-making when corporate directors make business decisions on an informed basis, in good faith and in the honest belief that the action taken is in the best interests of the company.¹³ The business judgment rule shields, to a large extent, the substantive bases for a corporate decision from judicial inquiry. The business judgment rule also ensures that management remains in the hands of the board of directors and protects courts from becoming too deeply implicated in internal corporate matters.¹⁴

¶ 20 Under Wis. Stat. § 180.0744, the corporation may create a special litigation committee *657 consisting of two or more independent directors appointed by a majority vote of independent directors present at a meeting of the board of directors. The independent special litigation committee determines whether the derivative action is in the best interests of the corporation. If the independent special litigation committee acts in good faith, conducts a reasonable inquiry upon which it bases its conclusions and concludes that the maintenance of the derivative action is not in the best interests of the corporation, the circuit court shall dismiss the derivative action. The statute thus requires the circuit court to defer to the business judgment of a properly composed and properly operating special litigation committee.¹⁵

¶ 21 The provisions of the Wisconsin statute relevant to the present case read as follows:

180.0744. Dismissal

(1) The court shall dismiss a derivative proceeding on motion by the corporation if the court finds, subject to the burden of proof assigned under sub. (5) or (6), that one of the groups specified in sub. (2) or (6) has determined, acting in good faith after conducting a reasonable inquiry upon which its conclusions are based, that maintenance of the derivative proceeding is not in the best interests of the corporation.

(2) Unless a panel is appointed under sub. (6), the determination in sub. (1) shall be made by any of the following:

****85** ...

***658** b) A majority vote of a committee consisting of 2 or more independent directors appointed by majority vote of independent directors present at a meeting of the board of directors, whether or not the voting, independent directors constitute a quorum.

¶ 22 The most common challenge to the decision of a special litigation committee, and the one made in the present case, is that the members are not independent. Given the finality of the ultimate decision of the committee to dismiss the action, judicial oversight is necessary to ensure that the special litigation committee is independent so that it acts in the corporation's best interest.¹⁶ At issue is whether the special litigation committee created in the present case under Wis. Stat. § 180.0744 was composed of independent directors as required by statute.

[5] ¶ 23 Although the plain language of Wis. Stat. § 180.0744 requires the directors who are members of the special litigation committee to be independent, the statute does not define the word “independent.”¹⁷ Rather, § 180.0744(3) merely instructs that whether a director on the committee is independent should not be determined solely on the basis of any of the following three factors set forth in the statute: (1) whether the director is nominated to the special litigation committee or elected by persons who are defendants in the derivative action, (2) whether the director is a defendant in the action, or (3) whether the act being challenged in the derivative action was approved by ***659** the director if the act resulted in no personal benefit to the director.

¶ 24 Wisconsin Stat. § 180.0744(3) provides as follows:

(3) Whether a director is independent for purposes of this section may not be determined solely on the basis of any one or more of the following factors:

(a) The nomination or election of the director by persons who are defendants in the derivative proceeding or against whom action is demanded.

(b) The naming of the director as a defendant in the derivative proceeding or as a person against whom action is demanded.

(c) The approval by the director of the act being challenged in the derivative proceeding or demand if the act resulted in no personal benefit to the director.

¶ 25 To determine the meaning of the word “independent” in Wis. Stat. § 180.0744, we examine the language of the statute, and its history, context, subject matter and purpose. *See UFE, Inc. v. LIRC*, 201 Wis.2d 274, 282, 548 N.W.2d 57 (1996).

¶ 26 The factors identified in Wis. Stat. § 180.0744(3) that cannot be *solely* determinative of whether a director is independent would appear at first blush to render a director not independent. For example, by instructing a court that whether a director is independent may not be determined solely on the basis that the director is a named defendant in the derivative action, Wis. Stat. § 180.0744(3)(b) appears to direct a court to adopt a relaxed, lenient standard for the word “independent.” Relying on this subsection and reviewing the legislative history, the circuit court concluded that “the threshold established by the legislature is ***660** extremely low. This conclusion is inescapable under a statute where a director who is a defendant in a derivative suit cannot be excluded from an independent committee by that fact alone.”¹⁸

****86** ¶ 27 A more nuanced examination of the statute shows, however, that the circuit court's reliance on Wis. Stat. § 180.0744(3) for an “extremely low threshold” standard is incorrect. The legislature understood the significance of the factors it listed. It allows the circuit court to give weight to these factors; the statute simply states that the presence of one or more of these factors is not solely determinative of the issue of whether a director is independent.

¶ 28 The legislature recognized, for example, that a shareholder could prevent the entire board of directors from serving on the special litigation committee merely by naming all the directors as defendants in the derivative action. Section 180.0744(3)(b) instructs ***661** a court to examine whether a director who is a member of the special litigation committee is a nominal defendant or a defendant with a personal interest in the dispute. The statute thus instructs the court that this factor is not solely determinative.

[6] ¶ 29 The Official Comment to § 7.44 of the Model Business Corporation Act upon which Wis. Stat. § 180.0744 is based¹⁹ explains that “the mere fact that a director has been named as a defendant ... does not cause the director to be considered not independent.... It is believed that a court

will be able to assess any actual bias in deciding whether the director is independent without any presumption arising out of ... the mere naming of the director as a defendant....”²⁰

¶ 30 We conclude that the circuit court's interpretation that the statute sets forth an “extremely low” threshold for determining whether a director is independent does not comport with the statute. The legislature directs in Wis. Stat. § 180.0744(3) that a court is not to adopt a *per se* exclusion of directors from the special litigation committee when these directors have certain relations with the corporation. Instead *662 the legislature directs a court to examine the characteristics of each member's relationship to a defendant director and the corporation carefully to determine whether the member is independent.

[7] ¶ 31 The statute requires judicial adherence to the decision of a special litigation committee that is independent and is operating in accordance with the statute. Judicial review to determine whether the members of the committee are independent and whether the committee's procedure complies with the statute is of utmost **87 importance, because the court is bound by the substantive decision of a properly constituted and acting committee. The power of a corporate defendant to obtain a dismissal of an action by the ruling of a committee of independent directors selected by the board of directors is unique in the law.²¹ The threshold established by the legislature in Wis. Stat. § 180.0744 to determine whether members of a committee are independent is decidedly not “extremely low,” as the circuit court stated. We conclude the legislature intended a circuit court to examine carefully whether members of a special litigation committee are independent.

¶ 32 The legislative history of Wis. Stat. § 180.0744 supports our interpretation of the word “independent” and the role of the circuit court.²²

¶ 33 Wisconsin Stat. § 180.0744 is based on § 7.44 of the Model Business Corporation Act,²³ which *663 was adopted in 1989. The Wisconsin version of the Model Business Corporation Act, Wis. Stat. § 180.0744, was created by 1991 Act 16, § 27, effective May 13, 1991. Thus our inquiry into the meaning of the word “independent” under the Wisconsin statute considers the history of the enactment of both the Wisconsin statute and the Model Business Corporation Act.

¶ 34 The language of Wis. Stat. § 180.0744(1), as originally adopted, differed from § 7.44 of the Model Business

Corporation Act in its final phrase. The final phrase of § 180.0744(1) as originally adopted, in contrast to the Model Business Corporation Act, provided that a court shall adhere to the decision of the special litigation committee to dismiss the derivative action “**unless the court finds that the members of the group so voting were not independent or were not acting in good faith**”²⁴ (emphasis added).

*664 ¶ 35 According to the bill-drafting file for Wis. Stat. § 180.0744, the purpose of the final clause, which could be considered merely redundant, was to make explicit that under the statute a court is to examine the rationality of the decision-making process and whether the members of the group were independent and acted in good faith.²⁵ The final clause “strikes a proper balance between shareholders' rights and the business judgment principle of corporate governance.”²⁶

**88 ¶ 36 According to the legislative history, the statute does not dictate judicial adherence to the decision of a special litigation committee unless the committee members are independent under the statute.²⁷ A court is required to adhere to the decision of the special litigation committee regarding dismissal of a derivative action on the ground that the committee's decision constitutes a matter of business judgment delegated by the board of directors to the committee. Thus, under the Wisconsin statute, judicial oversight is necessary to determine whether the members of the special litigation committee are independent.

*665 ¶ 37 In October 1991, the Committee on Business Corporation Law of the State Bar of Wisconsin sought amendment of Wis. Stat. § 180.0744(1), as the attorneys explained, to retain the purpose of the final phrase but to clarify that the final phrase of the Wisconsin statute did not change the burden of proof set forth in the statute.²⁸ The amendment proposed by the lawyers, described as “nonsubstantive and ‘housekeeping’ in nature,” and adopted by the legislature, thus expressly retains the concept of judicial review of whether members of the special litigation committee are independent.²⁹

¶ 38 The legislative history contradicts the conclusion of the circuit court and court of appeals in the present case that the legislature intended an “extremely low” threshold for determining whether members of a special litigation committee are independent. The legislative history of Wis. Stat. § 180.0744 demonstrates the legislature's intent that the courts scrutinize whether the members of a special

litigation committee are independent in order to protect the shareholders' and the corporation's interests.

III

¶ 39 We now discuss the appropriate test to be applied to determine whether directors who are members of a special litigation committee are independent *666 under Wis. Stat. § 180.0744. This question is one of first impression in Wisconsin. Nothing in the statute expressly states the factors to be examined to determine whether directors who are members of a committee are independent.

¶ 40 The Model Business Corporation Act (upon which Wis. Stat. § 180.0744 is based) builds on the law relating to special litigation committees developed by a number of states. We are therefore informed by the case law of other states,³⁰ and we derive from this case law the following test to determine whether a member of a special litigation committee is independent.³¹

*89 [8] [9] [10] ¶ 41 Whether members are independent is tested on an objective basis³² as of the time they are *667 appointed to the special litigation committee.³³ Considering the totality of the circumstances, a court shall determine whether a reasonable person in the position of a member of a special litigation committee can base his or her decision on the merits of the issue rather than on extraneous considerations or influences.³⁴ In other words, the test is whether a member of a committee has a relationship with an individual defendant or the corporation that would reasonably be expected to affect the member's judgment with respect to the litigation in issue. The factors a court should examine to determine whether a committee member is independent include, but are not limited to, the following:

(1) *A committee member's status as a defendant and potential liability.* Optimally members of a special litigation committee should not be defendants in the derivative action and should not be exposed to personal liability as a result of the action.

(2) *A committee member's participation in or approval of the alleged wrongdoing or financial benefits from the challenged transaction.* Optimally members of a special litigation committee should not have been members of the board of directors when the transaction in question occurred or was *668 approved. Nor should they have

participated in the transaction or events underlying the derivative action. Innocent or *pro forma* involvement does not necessarily render a member not independent, but substantial participation or approval or personal financial benefit should.

(3) *A committee member's past or present business or economic dealings with an individual defendant.* Evidence of a committee member's employment and financial relations with an individual defendant should be considered in determining whether the member is independent.

(4) *A committee member's past or present personal, family, or social relations with individual defendants.* Evidence of a committee member's non-financial relations with an individual defendant should be considered in determining whether the member is independent. A determination of whether a member is independent is affected by the extent to which a member is directly or indirectly dominated by, controlled by or beholden to an individual defendant.

(5) *A committee member's past or present business or economic relations with the corporation.* For example, if a member of the special litigation committee was outside counsel or a consultant to the corporation, this factor should be considered in determining whether the member is independent.

*90 (6) *The number of members on a special litigation committee.* The more members on a special litigation committee, the less weight a circuit court may assign to a particular disabling interest affecting a single member of the committee.

(7) *The roles of corporate counsel and independent counsel.* Courts should be more likely to find a special litigation committee independent if the *669 committee retains counsel who has not represented individual defendants or the corporation in the past.³⁵

¶ 42 Some courts and commentators have suggested that a "structural bias" exists in special litigation committees that taints their decisions.³⁶ They argue that members of a committee, appointed by the directors of the corporation, are instinctively sympathetic and empathetic towards their colleagues on the board of directors and can be expected to vote for dismissal of any but the most egregious charges. They assert that the committees are inherently biased and

untrustworthy.³⁷ Wisconsin Stat. § 180.0744 and the Model Business Corporation Act are designed to combat this possibility.³⁸

¶ 43 Wisconsin Stat. § 180.0744 requires that only independent directors vote to create a special litigation committee and only independent directors serve on the committee. The statute recognizes that independent directors serving as members of a special *670 litigation committee are capable of rendering an independent decision even though they are members of the board of directors which includes defendants in the derivative action.

[11] ¶ 44 A court should not presuppose that a special litigation committee is inherently biased. Although members of a special litigation committee may have experiences similar to those of the defendant directors and serve with them on the board of directors, the legislature has declared that independent members of a special litigation committee are capable of rendering an independent decision. The test we set forth today is designed, as is the statute, to overcome the effects of any “structural bias.”

[12] [13] ¶ 45 A circuit court is to look at the totality of the circumstances. A finding that a member of the special litigation committee is independent does not require the complete absence of any facts that *671 might point to non-objectivity. A director may be independent even if he or she has had some personal or business relation with an individual director accused of wrongdoing.³⁹ Although the totality of **91 the circumstances test does not necessitate the complete absence of any facts that might point to a member not being independent, a circuit court is required to apply the test for determining whether a member is independent with care and rigor. If the members are not independent, the court will, in effect, be allowing the defendant directors to render a judgment on their own alleged misconduct. The value of a special litigation committee depends on the extent to which the members of the committee are independent.

[14] ¶ 46 It is vital for a circuit court to review whether each member of a special litigation committee is independent. The special litigation committee is, after all, the “only instance in American Jurisprudence where a defendant can free itself from a suit by merely appointing a committee to review the allegations of the complaint....”⁴⁰ We agree with the Delaware Court of Chancery that the trial court must be “certain that the SLC [special litigation committee] is truly independent.”⁴¹ While ill suited to assessing business

judgments, courts are well suited by experience to evaluate whether members of a special litigation committee are independent.

¶ 47 The test we set forth attains the balance the legislature intended by empowering corporations to dismiss meritless derivative litigation through special litigation committees, while checking this power with appropriate judicial oversight over the composition and conduct of the special litigation committee.

IV

[15] ¶ 48 The circuit court declined to grant summary judgment for the defendant because there was a *672 dispute of material facts. After seven days of testimony on the issue of whether the members of the special litigation committee were independent, the circuit court made findings of fact and concluded that the threshold the legislature established for determining whether the members of the committee were independent is “extremely low.” Applying this “extremely low” standard, the circuit court determined that the members of the special litigation committee in the present case were independent.⁴²

¶ 49 We briefly explore the relations of the members of the special litigation committee to the corporation and the defendant Culea. In this case no member of the special litigation committee is a named defendant in the derivative action.

¶ 50 One member of the committee, Robert Bonk, received a \$25,000 bonus at the same meeting of the compensation committee at which Culea's challenged bonus was approved. The circuit court found that “while [Bonk] did receive a bonus at the same meeting of the board where Mr. Culea received his bonus, it does not appear that there was a quid pro quo or any other type of linkage between the two bonuses. In fact, it should be noted that the plaintiff [Einhorn] has not made Bonk's \$25,000 bonus a subject of this lawsuit.” Einhorn has made the bonus an issue in this court.

*673 ¶ 51 Bonk is an employee of the corporation, is a subordinate of Culea and considers Culea a friend. Bonk acknowledged that it would be “very difficult for [him] to even consider the possibility that **92 Mr. Culea would do something improper....”⁴³ Bonk's ability to independently evaluate the litigation may have been compromised by his own admission. The circuit court merely stated that “with the exception of him being an employee of Northern Labs,

this Court fails to find any inherent basis upon which his independence could be challenged.”

¶ 52 Outside counsel retained by the special litigation committee questioned whether Robert Bonk was independent: “[Bonk's] independence is questionable.... Because his interests in the financial outcome ~~would~~ [strikethrough in original] was affected but it is such a small amount.... The input of [Bonk] throughout the process may taint the vote because his independence may be questioned.”⁴⁴ Whether Bonk was independent should be determined on the basis of his employment status, his financial interest in the outcome and his personal relation with Culea.

¶ 53 Another member of the committee, John Beagle, was characterized by the circuit court as Einhorn's “right-hand man.” Beagle admitted that he and Einhorn “have a very good business relationship” and are “also very good friends.” Beagle wrote, in explaining his lone vote to maintain the derivative action, that “the special litigation committee is not, and never was, unbiased or independent ... each of us is too close to one party or the other to have a chance at being independent....”⁴⁵ *674 John Beagle, plaintiff Einhorn's good friend and close business partner, openly admits that he was not independent.⁴⁶

¶ 54 The other two members of the special litigation committee had personal and social relationships with Culea and Culea's wife. Einhorn argues strenuously that Culea's neighbor and friend, Dwight Chewning, and Culea's wife's friend, Lolita Chua, were not independent. The exact extent of these friendships is vigorously contested by the parties, but the existence of some relationship is evidenced in the record.

¶ 55 The circuit court did not make findings of fact specifying the relationships of Chewning and Chua to Culea other than describing Chewning as a “neighbor” and Chua as a “social friend” of Mrs. Culea. In its discussion of Chewning and Chua, the circuit court examined their performance as witnesses and as members of the special litigation committee. While the care, attention and sense of individual responsibility of a member may touch on the issue of whether the member was independent, the test is primarily concerned with whether factors exist at the time the committee was formed that would prevent a reasonable person from *675 basing his or her decisions on the merits of the issue. Whether members of the special litigation committee are independent

is critical. “Good faith, reasonable inquiry, and the best interests of the corporation are not enough.”⁴⁷

**93 [16] ¶ 56 As we stated previously, mere acquaintanceship and social interaction are not *per se* bars to finding a member independent. Relationships with an individual defendant and the corporation are, however, factors the circuit court must consider in the totality of circumstances.

¶ 57 Einhorn also argues strenuously that the role of the corporation's counsel tainted the formation of the special litigation committee, in that the corporation's counsel was acting both as Culea's personal counsel and as the corporation's counsel. Relatively late in its investigation the special litigation committee retained a separate law firm from Washington, D.C., to act as its counsel. But the exact extent of the corporation's counsel's role in advising the special litigation committee is contested. The circuit court did not make findings about the roles of the corporation's counsel and outside counsel. The role of the corporation's counsel should be considered as one of the circumstances in determining whether the committee is independent. Several courts have stated that retention of objectively independent counsel is highly recommended, although failure to do so does not necessarily prevent a special litigation committee from being independent.⁴⁸

*676 ¶ 58 The circuit court did not apply the totality of the circumstances standard to determine whether a reasonable person in the position of the member of the special litigation committee could base his or her decision on the merits of the issue rather than on extraneous conditions or influences. Considered together, the relationships in the present case raise significant questions concerning whether the members of the special litigation committee were independent.⁴⁹ *677 The decision of this court is not intended to cast doubt on any committee member's integrity, honesty or hard work on the special litigation committee. Rather, we are concerned that, at the time of the formation of the special litigation committee, the members of the committee had relationships with the individual defendant and the corporation that call into question whether a reasonable person could base his or her decision on the merits of the issue rather than on extraneous considerations or influences.

[17] ¶ 59 The application of a statute to undisputed facts is ordinarily a question of law that this court determines independently of the circuit court and the court of appeals, benefiting from the analyses of these courts. But in this case

the facts are in dispute, and the circuit court has not made sufficient findings of fact upon which **94 this court can apply the legal test set forth. Accordingly, we remand the cause to the circuit court to make findings of fact and to apply the proper legal standard to the facts of this case.

The decision of the court of appeals is reversed and the cause is remanded.

Parallel Citations

612 N.W.2d 78, 2000 WI 65

Footnotes

- 1 *Einhorn v. Culea*, 224 Wis.2d 856, 591 N.W.2d 908 (Ct.App.1999).
- 2 For purposes of this opinion, Northern Labs, Inc., and Northern Labs Manufacturing, Inc., are treated as the same corporate entity, and will be referred to collectively as "Northern Labs."
- 3 Unless otherwise noted, all references to the Wisconsin Statutes are to the 1997-98 volumes. Wisconsin Stat. § 180.0744, the sole statute in question in this appeal, was adopted and amended in 1991. It has not been amended thereafter.
Wisconsin Stat. § 180.0744(1) reads as follows:
180.0744. Dismissal
(1) The court shall dismiss a derivative proceeding on motion by the corporation if the court finds that [a special litigation committee] ... has determined, acting in good faith after conducting a reasonable inquiry upon which its conclusions are based, that maintenance of the derivative proceeding is not in the best interests of the corporation....
- 4 Culea's motion to strike Einhorn's brief because it purportedly exceeds the 11,000-word limit by 234 words, Wis. Stat. § (Rule) 809.19(8)(c), is denied. No costs are awarded.
- 5 Any disagreements among the parties about the exact percentages of ownership are not material to our discussion or holding.
- 6 Prior to the board meeting, Mertz and two other stockholders had sold their holdings.
- 7 In addition to asserting that the four directors who became members of the special litigation committee were not independent, Einhorn also asserts that no vote was taken to appoint the special litigation committee, as required by Wis. Stat. § 180.0744(2)(b). While the court of appeals recognized that "the creation of the SLC [special litigation committee] could have been better documented," the court of appeals rejected this argument. *Einhorn v. Culea*, 224 Wis.2d 856, 869-70, 591 N.W.2d 908 (Ct.App.1999). While the record does not reflect that a formal vote was taken to create the special litigation committee, it suggests that the formation of the committee was done by consensus of the four directors who ultimately served on the special litigation committee.
- 8 The lone dissenting vote was John Beagle, Einhorn's business partner.
- 9 The issues of whether the members acted in good faith and conducted a reasonable inquiry are not before us. Einhorn does not challenge these conclusions.
- 10 A derivative action is defined in Wis. Stat. § 180.0740(2). For a discussion of derivative actions and special litigation committees, *see*, e.g., John C. Coffee, Jr., and Donald E. Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 Colum. L.Rev. 261 (1981); Michael P. Dooley and E. Norman Veasley, *The Role of the Board in Derivative Litigation: Delaware Law and the Current ALI Proposals Compared*, 44 Bus. Law. 503 (1989); James L. Rudolph and Gustavo A. del Puerto, *The Special Litigation Committee: Origin, Development, and Adoption Under Massachusetts Law*, 83 Mass. L.Rev. 47 (1998); Meg Shevach, *Deciding Who Should Decide to Dismiss Derivative Suits*, 39 Emory L.J. 937 (1990); Carol B. Swanson, *Juggling Shareholder Rights and Strike Suits in Derivative Litigation: The ALI Drops the Ball*, 77 Minn. L.Rev. 1339 (1993).
- 11 2 Model Business Corporation Act Annotated, Introductory Comment to Subchapter D, Derivative Proceedings, § 7.40 at 7-252-253 (3d ed. 1997 Supp.).
- 12 *Holmstrom v. Coastal Indus., Inc.*, 645 F.Supp. 963, 965 (N.D. Ohio 1984).
- 13 "The concept of the litigation oversight committee flows from the business judgment rule which, in short, constitutes judicial recognition of the fact that a private corporation should, generally speaking, have the right to control its destiny respecting the prosecution of claims held by the corporation." *Holmstrom v. Coastal Indus., Inc.*, 645 F.Supp. 963, 964 (N.D. Ohio 1984).
- 14 In *United Copper Securities Co. v. Amalgamated Copper Co.*, 244 U.S. 261, 263-64, 37 S.Ct. 509, 61 L.Ed. 1119 (1917), in which Justice Brandeis contemplated the question of whether the business judgment rule could be employed to insulate from judicial scrutiny the conclusions of management not to initiate litigation, he wrote:
Whether or not a corporation shall seek to enforce in the courts a cause of action for damages is, like other business questions, ordinarily a matter of internal management, and is left to the discretion of the directors, in the absence of instruction by vote of the stockholders. Courts interfere seldom to control such discretion intra vires the corporation, except where the directors

are guilty of misconduct equivalent to a breach of trust, or where they stand in a dual relation which prevents an unprejudiced exercise of judgment....

15 2 Model Business Corporation Act Annotated, Introductory Comment to Subchapter D, Derivative Proceedings, § 7.40 at 7-253 (3d ed. 1997 Supp.).

16 2 Model Business Corporation Act Annotated, Introductory Comment to Subchapter D, Derivative Proceedings, § 7.40 at 7-253 (3d ed. 1997 Supp.).

17 The interpretation of a statute is a question of law that this court determines independently of the circuit court and court of appeals, benefiting from their analyses.

18 The circuit court declared:

While reasonable persons may take issue in a generic sense with the findings made above [regarding the independence of the members of the special litigation committee], what is abundantly clear from the record and not even subject to interpretation is that the criteria for independence established under Wisconsin Statute 180.0744(3) was met. Indeed, independence is so broadly defined that the independence of a director may not be judged solely upon: (1) whether a director was elected by a defendant in the derivative suit, (2) whether an elected director is a defendant in the suit, or (3) whether an elected director approved of the challenged act, as long as that director received no personal benefit from the act.

After a review of the legislative history submitted by the plaintiff, there does not appear to be anything within that history of the statute that would challenge the conclusion that the threshold established by the legislature in determining independence is extremely low. The conclusion is inescapable under a statute where a director who is a defendant in a derivative suit cannot be excluded from an independent committee by that fact alone.

19 A court may examine official comments that accompany a statute to determine legislative intent. *See, e.g., Armor All Prod. v. Amoco Oil Co.*, 194 Wis.2d 35, 50, 533 N.W.2d 720 (1995); *Sterman v. Hornbeck*, 156 Wis.2d 556, 564, 457 N.W.2d 874 (Ct.App.1990) (examining Model Business Corporation Act to interpret statute); *Lyons v. Menominee Enter., Inc.*, 67 Wis.2d 504, 509, 227 N.W.2d 108 (1975) (same).

20 *See* 2 Model Business Corporation Act Annotated, Official Comment to § 7.44 at 7-343 (3d ed. 1997 Supp.). The Official Comment refers to subsection (c)(2) of § 7.44 of the Model Business Corporation Act. The Wisconsin legislature renumbered the Act while retaining the language of (c)(2) verbatim, and references in this opinion are to Wis. Stat. § 180.0744(3)(b).

21 *Lewis v. Fuqua*, 502 A.2d 962, 967 (Del.Ch.1985).

22 The legislative history of Wis. Stat. § 180.0744 is available on microfiche at the Legislative Reference Bureau, Madison, Wisconsin.

23 *See* Christopher S. Berry, Kenneth B. Davis, Jr., Frank C. DeGuire and Clay R. Williams, *Wisconsin Business Corporation Law* at 7-107 (State Bar of Wisconsin CLE Books 1992).

24 The original enactment of Wis. Stat. § 180.0744(1) provided:

(1) The court shall dismiss a derivative proceeding on motion by the corporation if one or more of the groups specified in sub. (2) or (6) has determined in good faith after conducting a reasonable inquiry upon which its conclusions are based that maintenance of the derivative proceeding is not in the best interests of the corporation, **unless the court finds that the members of the group so voting were not independent or were not acting in good faith** (emphasis of the final phrase added).

See 1991 Wis. Act 16, § 27.

Section 7.44(a) of the Model Business Corporation Act reads as follows:

(a) A derivative proceeding shall be dismissed by the court on motion by the corporation if one of the groups specified in subsections (b) or (f) has determined in good faith after conducting a reasonable inquiry upon which its conclusions are based that the maintenance of the derivative proceeding is not in the best interests of the corporation.

25 Letter from Attorney Jeffrey Bartell to Senator Charles Chvala dated January 23, 1991, Bill-Drafting File, 1991 Wis. Act 16, Legislative Reference Bureau, Madison, Wisconsin.

26 Letter from Attorney Jeffrey Bartell to Senator Charles Chvala dated January 23, 1991, Bill-Drafting File, 1991 Wis. Act 16, Legislative Reference Bureau, Madison, Wisconsin.

27 In *Houle v. Low*, 407 Mass. 810, 556 N.E.2d 51, 58 (1990), the Massachusetts Supreme Judicial Court explained:

The value of a special litigation committee is coextensive with the extent to which that committee truly exercises business judgment. In order to ensure that special litigation committees do act for the corporation's best interest, a good deal of judicial oversight is necessary in each case.... At a minimum, a special litigation committee must be independent, unbiased, and act in good faith.

28 Memorandum to the Committee on Business Corporation Law from Jeffrey Bartell and Molly Martin dated October 31, 1991, Bill-Drafting File, 1991 Wis. Act 16, Legislative Reference Bureau, Madison, Wisconsin.

29 *See* 1991 Wis. Act 173, § 2 (effective April 28, 1992).

See also Christopher S. Berry, Kenneth B. Davis, Jr., Frank C. DeGuire and Clay R. Williams, *Wisconsin Business Corporation Law* at 7-116 (State Bar of Wisconsin CLE Books 1992).

- 30 See 2 Model Business Corporation Act Annotated, Official Comment to § 7.44 at 7-341-349 (3d ed. 1997 Supp.).
- 31 For discussions and applications of various versions of this test, see, e.g., *Strougo v. Padegs*, 27 F.Supp.2d 442, 448-451 (1998); *In re Oracle Sec. Litig.*, 852 F.Supp. 1437, 1441-42 (1994); *Johnson v. Hui*, 811 F.Supp. 479, 486-87 (N.D.Cal.1991); *Peller v. The Southern Co.*, 707 F.Supp. 525, 527-28 (1988); *Kaplan v. Wyatt*, 499 A.2d 1184, 1189-90 (Del.1985); *Aronson v. Lewis*, 473 A.2d 805, 814-16 (Del.1984); *Zapata Corp. v. Maldonado*, 430 A.2d 779 (1981); *Millsap v. American Fam. Corp.*, 208 Ga.App. 230, 430 S.E.2d 385, 387-88 (1993); *Houle v. Low*, 407 Mass. 810, 556 N.E.2d 51, 58-59 (1990); *Auerbach v. Bennett*, 47 N.Y.2d 619, 419 N.Y.S.2d 920, 393 N.E.2d 994, 1001-02 (1979); *Davidowitz v. Edelman*, 153 Misc.2d 853, 583 N.Y.S.2d 340, 343-44 (N.Y.Sup.Ct.1992); *Lewis v. Boyd*, 838 S.W.2d 215, 224-25 (Tenn.Ct.App.1992). See also James L. Rudolph & Gustavo A. del Puerto, *The Special Litigation Committee: Origin, Development, and Adoption Under Massachusetts Law*, 83 Mass. L.Rev. 47, 51-52 (1998).
- 32 “[Courts] have looked to an array of objective factors ... as criteria for evaluating the disinterestedness and independence of directors....” 1 Roger J. Magnuson, *Shareholder Litigation* § 8.17.60 (1993).
- 33 An independent member might stop being independent while serving on a special litigation committee.
- 34 This standard for determining whether a person is independent fits the dictionary definitions of independent. *Black's Law Dictionary* at 774 (7th ed.1999) defines “independent” as “not subject to the control or influence of another.” The *American Heritage Dictionary of the English Language* at 917 (3d ed.1992) defines “independent” as, among other things, “free from the influence, guidance, or control of another or others.”
- 35 For a discussion of cases involving the independent standard for members of special litigation committees, see Jay M. Zitter, *Propriety of Termination of Properly Initiated Derivative Action by “Independent Committee” Appointed by Board of Directors Whose Actions (Or Inaction) Are Under Attack*, 22 A.L.R. 4th (1983 and 1999 Supp.).
- 36 See, e.g., *Houle v. Low*, 407 Mass. 810, 556 N.E.2d 51, 54 (1990); *Miller v. Register & Tribune Syndicate Inc.*, 336 N.W.2d 709, 718 (Iowa 1983); Carol B. Swanson, *Juggling Shareholder Rights and Strike Suits in Derivative Litigation: The ALI Drops the Ball*, 77 Minn. L.Rev. 1339, 1356-59 (1993).
- 37 See, e.g., George W. Dent, Jr., *The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit?*, 75 Nw. U.L.Rev. 96, 98 (1980).
- 38 See 2 Model Business Corporation Act Annotated, Official Comment to § 7.44 at 7-342 (3d ed. 1997 Supp.).
- 39 See *In re Oracle Securities Litigation*, 852 F.Supp. 1437, 1442 (N.D.Cal.1994), stating:

A “totality of the circumstances” test does not, however, necessitate the complete absence of any facts which might point to non-objectivity. In any business setting, associations and contacts of the type which [the committee member] has had with some of the individual defendants and [the corporation] are certainly neither inappropriate nor such as to suggest that [the committee member] would not faithfully discharge his obligations to [the corporation's] shareholders. Business dealings seldom take place between complete strangers and it would be a strained and artificial rule which required a director to be unacquainted or uninvolved with fellow directors in order to be regarded as independent.
- 40 *Lewis v. Fuqua*, 502 A.2d 962, 967 (Del.Ch.1985).
- 41 *Lewis v. Fuqua*, 502 A.2d 962, 967 (Del.Ch.1985).
- 42 The question of which party has the burden of proving, Wis. Stat. § 180.0744(5), whether members of the special litigation committee in the present case were independent has been raised in this case. At the trial before the circuit court, plaintiff Einhorn presented his case first. We do not address the issue of burden of proof because it was not fully analyzed or fully briefed by the parties.
- 43 See 12/19/96 Bonk testimony, R. 206 at 35 (reproduced at Einhorn's Appendix at 168).
- 44 See “Chewning Notes of 5/22/95 Conversations With Outside Counsel,” Einhorn's Appendix at 95.
- 45 See letter from Beagle to Chewning, June 14, 1995, Einhorn's Appendix at 127.
- 46 At oral argument, counsel for Culea asserted that Einhorn's trial counsel conceded that Beagle was independent. It was only when new appellate counsel was hired, Culea argues, that Einhorn challenged whether Beagle was independent.

Wisconsin Stat. § 180.0744(3) focuses the inquiry of “independent” on the connections of a member of a special litigation committee to an individual defendant and the corporation, not on the connections with a plaintiff. See Wis. Stat. § 180.0744(3). We do not address the issue of a member's relationship with the plaintiff.
- 47 See Christopher S. Berry, Kenneth B. Davis, Jr., Frank C. DeGuire and Clay R. Williams, *Wisconsin Business Corporation Law* at 7-116 (State Bar of Wisconsin CLE Books 1992).
- 48 See, e.g., *In re Par Pharm. Inc.*, 750 F.Supp. 641, 647 (S.D.N.Y.1990) (“Both New York and Delaware law contemplate that a special litigation committee be represented by independent counsel.”); *Kaplan v. Wyatt*, 499 A.2d 1184, 1190 (Del.1985) (although use of in-house counsel is not recommended, it is not fatal to the special litigation committee's investigation).

A comment to Wis. SCR 20:1.13 of the Code of Professional Conduct states the following about derivative actions:

The question can arise whether counsel for the organization may defend such an action. The proposition that the organization is the lawyer's client does not alone resolve the issue. Most derivative actions are a normal incident of an organization's affairs, to be defended by the organization's lawyer like any other suit. However, if the claim involves serious charges of wrongdoing by those in control of the organization, a conflict may arise between the lawyer's duty to the organization and the lawyer's relationship with the board. In those circumstances, Rule 1.7 [relating to conflict of interest] governs who should represent the directors and the organization.

- 49 Wisconsin Stat. § 180.0744 draws no distinction between publicly held corporations and closely held corporations. *See* §§ 180.1801-180.1837 relating to close corporations. We acknowledge that it may be difficult for closely held corporations to assemble special litigation committees. If it is difficult for the corporation to create an independent special litigation committee, the remedy has been provided by the legislature. The corporation may move the court, pursuant to Wis. Stat. § 180.0744(6), to “appoint a panel of one or more independent persons to determine whether maintenance of the derivative proceedings is in the best interests of the corporation.”

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662 N.W.2d 876
Supreme Court of Minnesota.

George JANSSEN, et al., Respondents,
v.
BEST & FLANAGAN, et al., Defendants,
and
Minneapolis Police Relief
Association, Petitioner, Appellant.

No. CX-01-2207. | May 22, 2003.

Former members and trustees of police pension fund, a nonprofit corporation, brought derivative action against law firm for legal malpractice, naming corporation as nominal defendant. The District Court, Hennepin County, Bruce A. Peterson, J., dismissed action. Plaintiffs appealed. The Court of Appeals, 645 N.W.2d 495, reversed and remanded. Upon further appeal, the Supreme Court, Meyer, J., held that: (1) as a matter of first impression, boards of nonprofit corporations could receive the protection of the business judgment rule; (2) Minnesota Nonprofit Corporations Act did not prohibit corporations from appointing independent committees with authority to decide whether the corporation should join a member's derivative suit; (3) board failed to establish that investigator, appointed to determine whether corporation should join member's derivative suit, was independent and acted in good faith; and (4) board was not entitled to remedy defect in first investigation.

Affirmed.

Hanson, J., concurred in part and dissent in part with opinion in which Blatz, C.J., joined.

***878 Syllabus by the court**

1. The boards of nonprofit corporations may receive the protection of the business judgment rule.
2. Minnesota Statutes § 317A.241 (2002) does not prohibit nonprofit corporations from appointing independent committees with the authority to decide whether the corporation should join a member's derivative suit.
3. Because the investigation conducted by appellant's litigation committee lacked independence and good faith, the conclusion of that committee does not deserve deference from the court as a business decision.

4. When the committee authorized with making a business decision for the corporation lacks independence and good faith, a member's derivative suit proceeds on its merits.

Attorneys and Law Firms

***879** Patrick J. McLaughlin, Eric Moutz, Dorsey & Whitney, LLP, Minneapolis, for appellant.

William J. Mavity, Pamela Marie Miller, Mavity & Associates, Minneapolis, for respondents.

Martin J. Costello, Hughes & Costello, St. Paul, for Amicus Curiae, Minnesota Teamsters Joint Council 32, et al.

Heard, considered, and decided by the court en banc.

Opinion

OPINION

MEYER, Justice.

We are called on to decide certain questions of first impression regarding the law of nonprofit corporations in Minnesota. The principal issue concerns how a nonprofit board may respond to a member's demand to commence legal action on behalf of the association. We also consider the degree of deference that a district court may give to a nonprofit board's decision to reject a member's demand to commence legal action.

The board of directors of the Minneapolis Police Relief Association (MPRA) made an improvident investment in a company known as Technimar and lost approximately fifteen million dollars. Certain members of MPRA (Janssen, et al., whom we will refer to collectively as "Janssen") brought a derivative suit on behalf of MPRA against Best & Flanagan alleging attorney malpractice with respect to the Technimar investment. MPRA appointed special counsel to review the merits of the derivative suit. Special counsel concluded that proceeding with the derivative suit would not be in the best interests of MPRA and MPRA moved to dismiss the suit. The district court treated special counsel as a special litigation committee, applied the business judgment rule to the committee's decision not to proceed with the derivative action, and dismissed Janssen's suit. The court of appeals reversed, concluding that the legislature had not granted nonprofit corporations authority to appoint special litigation committees, and the district court was precluded from deferring to the decision of MPRA's special counsel.

MPRA petitioned for review, seeking a reversal of the court of appeals' decision.

MPRA is a Minnesota nonprofit corporation that administers a pension plan for Minneapolis police officers hired before June 15, 1980. Minn.Stat. § 423B.01-.04 (2002). MPRA was formed under and is subject to Minn.Stat. ch. 317A (2002), the Minnesota Nonprofit Corporation Act, and is governed by a board of nine directors. *See* Minn.Stat. § 423B.05, subd. 1 (2002).

In 1996 and 1997, MPRA lost approximately fifteen million dollars that it had invested with David Welliver in a company called Technimar. The circumstances surrounding this loss were the subject of several investigations and at least two prior lawsuits. The most important aspect of this history for the instant case is that two law firms, Jones, Day, Reavis and Pogue (Jones Day) and Dorsey & Whitney, LLP (Dorsey Whitney), had already conducted investigations surrounding some of the issues.

Janssen alleges in this action that MPRA's former attorneys, Best & Flanagan, committed malpractice in representing MPRA during and after the Welliver investments were made in 1996 and 1997. Janssen alleges, among other claims, that Best & Flanagan attorneys served as general counsel to MPRA and were negligent *880 in failing to conduct a "due diligence" inquiry into the Welliver investment. In bringing this derivative suit, Janssen did not have an attorney-client relationship with Best & Flanagan, so their suit depended upon MPRA joining them as a plaintiff.

In response to this lawsuit, MPRA appointed attorney Robert A. Murnane (Murnane) as special counsel to investigate Janssen's claims and determine whether MPRA should join the derivative suit. The MPRA board issued a resolution in June of 2000 instructing Murnane to conduct an independent review and evaluate the derivative lawsuit to determine on behalf of MPRA's board of directors whether or not MPRA should join in legal action against Best & Flanagan. The resolution specifically instructed Murnane to "not reinvestigate, verify or otherwise attempt to prove or disprove the factual findings, determinations, events or circumstances" described in the prior investigative reports of Jones Day and Dorsey Whitney and a set of discovery materials in a related lawsuit. Murnane was specifically instructed to "accept as correct" the factual findings of these reports and discovery materials. Murnane was not limited, however, by the conclusions of the previous reports.

Murnane reviewed "thousands of pages of reports, documents and deposition transcripts" over a few months in investigating the merits of a malpractice action against Best & Flanagan. However, the record does not indicate that he conducted any of his own investigation, nor did he personally speak to the Janssen claimants or their counsel. Murnane submitted his report to the MPRA board on September 26, 2000, concluding that "the totality of the materials reviewed does not support a finding that Best & Flanagan committed legal malpractice in its handling of the MPRA affairs," and that "to spend money in the pursuit of a legal malpractice claim against Best & Flanagan would not be prudent use of the MPRA funds." Following submission of Murnane's report, the MPRA board brought a motion to dismiss the instant lawsuit under the principle of law that the court should defer to the business judgment of Murnane, MPRA's special litigation committee.

In considering MPRA's motion to dismiss, the district court described the appropriate role that special litigation committees play in acting on behalf of for-profit corporations. The court determined that a nonprofit corporation is also authorized to utilize the special litigation committee procedure. The court treated Murnane as a special litigation committee and applied the business judgment rule to the committee's report. Under the business judgment rule enunciated by the court, it examined only whether the committee conducted its investigation with independence and good faith. The court concluded that "[Murnane's] investigation cannot survive even this limited review." The court could not find that Murnane was independent because "he was told by the board of directors what to believe." The court could not find good faith because there was no indication from Murnane that he sought or received input from the plaintiffs and the court was left to assume that such input was not sought because the board's instructions limited the scope of the investigation. Finally, the court could not clearly discern whether Murnane was offering legal advice or, in fact, rendering a business judgment decision.

Rather than deny MPRA's motion to dismiss the Janssen lawsuit, the district court postponed a decision on the motion *881 to allow MPRA an opportunity to remedy the deficiencies in MPRA's delegation of authority to its special litigation committee. The court instructed MPRA that if it sought deference for its committee's litigation decision, the court would not grant such deference unless and "until adequate evidence of independence and good faith is submitted by the MPRA, and until it is clear that Murnane has rendered a business judgment."

Consequently, MPRA issued a second resolution in December of 2000 to Murnane, declaring that he was to function as a special litigation committee, not being limited in any way as to how to conduct his investigation or what material he may consider: “[s]pecial counsel shall have complete independence and may undertake whatever good faith investigation he chooses.” The resolution asked Murnane to exercise his “business judgment” regarding whether it was in the best interest of MPRA to join in the derivative suit. Murnane conducted an investigation that included meeting with certain of the named plaintiffs in the action and the involved attorneys at Best & Flanagan. Murnane submitted a second report and in that report concluded it would be a “poor business judgment” for MPRA to join in litigation against Best & Flanagan. MPRA renewed its motion to dismiss. The district court reviewed Murnane’s second report and concluded that MPRA’s special litigation committee (Murnane) had conducted an investigation that was independent and conducted in good faith. The court deferred to the committee’s business judgment and granted MPRA’s motion to dismiss the complaint against Best & Flanagan.

Janssen appealed and the court of appeals reversed. It concluded that a nonprofit corporation lacks the statutory authority to appoint a special litigation committee to evaluate derivative claims. Additionally, the court concluded that even if a nonprofit corporation has the authority to appoint a special litigation committee, in this case the special litigation committee failed to meet the threshold test of the business judgment rule. The court reversed and remanded for trial. This appeal followed.

I.

[1] We concern ourselves with two questions: (1) whether the Minnesota Nonprofit Corporations Act prohibits a nonprofit corporation’s board of directors from establishing an independent committee with authority to make decisions about derivative lawsuits; and (2) whether Murnane, as special counsel, displayed sufficient independence and good faith to be entitled to the deference of the business judgment rule. We exercise de novo review of the primary issues in this case, as they involve statutory interpretation and novel questions of law. *State v. Loge*, 608 N.W.2d 152, 155 (Minn.2000). We also note that other states have recently held that they will review de novo a decision of a district court to dismiss a derivative suit. See *Brehm v. Eisner*, 746 A.2d 244,

253 (Del.2000); *In re PSE & G S’holder Litig.*, 173 N.J. 258, 801 A.2d 295, 313 (2002).

A. The Business Judgment Rule and Derivative Lawsuits

To resolve this case we must strike a balance between two competing interests in the judicial review of corporate decisions. See *PSE & G*, 801 A.2d at 306. On one hand, courts recognize the authority of corporate directors and want corporations to control their own destiny. *Stoner v. *882 Walsh*, 772 F.Supp. 790, 796 (S.D.N.Y.1991). On the other hand, courts provide a critical mechanism to hold directors accountable for their decisions by allowing shareholder derivative suits. See *Barrett v. Southern Conn. Gas Co.*, 172 Conn. 362, 374 A.2d 1051, 1055 (1977) (remarking that “[i]f the duties of care and loyalty which directors owe to their corporations could be enforced only in suits by the corporation, many wrongs done by directors would never be remedied” (citation omitted)); *Brown v. Tenney*, 125 Ill.2d 348, 126 Ill.Dec. 545, 532 N.E.2d 230, 232 (1988) (stating that “[t]he derivative suit is a device to protect shareholders against abuses by the corporation, its officers and directors, and is a vehicle to ensure corporate accountability”). Because shareholder-derivative litigation is not an everyday occurrence in Minnesota’s courts, we address these issues for the first time.

Courts have attempted to balance these two competing concerns by establishing a “business judgment rule” that grants a degree of deference to the decisions of corporate directors. The business judgment rule was developed by state and federal courts to protect boards of directors against shareholder claims that the board made unprofitable business decisions. “The business judgment rule is a presumption protecting conduct by directors that can be attributed to any rational business purpose.” Dennis J. Block, et al., *The Business Judgment Rule: Fiduciary Duties of Corporate Directors* 18 (5th ed.1998). The business judgment rule means that as long as the disinterested director(s) made an informed business decision, in good faith, without an abuse of discretion, he or she will not be liable for corporate losses resulting from his or her decision. *Id.* at 39. Two major reasons buttress the decision to grant a degree of deference to corporate boards. First, protecting directors’ reasonable risks is considered positive for the economy overall, as those risks allow businesses to attract risk-averse managers, adapt to changing markets, and capitalize on emerging trends.¹ Second, courts are ill-equipped to judge the wisdom of business ventures and have been reticent to replace a well-meaning decision by a corporate board with their own. See,

e.g., *Auerbach v. Bennett*, 47 N.Y.2d 619, 419 N.Y.S.2d 920, 393 N.E.2d 994, 1000 (1979).

[2] [3] [4] [5] [6] [7] [8] [9] Where the shareholders of a corporation believe the board has acted improperly, corporate law recognizes the shareholders' ability to bring a derivative lawsuit. Derivative suits allow shareholders to bring suit against wrongdoers on behalf of the corporation, and force liable parties to compensate the corporation for injuries so caused. *Tenney*, 126 Ill.Dec. 545, 532 N.E.2d at 233. A derivative action actually belongs to the corporation, but the shareholders are permitted to bring the action where the corporation has failed to take action for itself. *See id.* Because of the business judgment rule, however, not all shareholders' derivative *883 suits proceed on their merits. While derivative suits may benefit a corporation, any benefit must be weighed against the possibility that disgruntled shareholders will bring nuisance lawsuits with little merit and that even legitimate suits may not be worth pursuing when the likelihood of victory is compared with the time, money, and hostility necessary to win. The substantive decision about whether to pursue the claims advanced in a shareholder's derivative action involves "the weighing and balancing of legal, ethical, commercial, promotional, public relations, fiscal and other factors familiar to the resolution of many if not most corporate problems." *Auerbach*, 419 N.Y.S.2d 920, 393 N.E.2d at 1002. The careful balancing of those factors is best done by the board of directors, which is familiar with the appropriate weight to attribute to each factor given the company's product and history. Thus, courts apply the business judgment rule when evaluating the decision by a board of directors whether to join or quash a derivative suit belonging to the corporation. *Block, supra*, at 1702-03.

Having established the principles by which we apply the business judgment rule to a for-profit corporate board's decision whether to join a derivative lawsuit, we consider whether to grant similar deference to nonprofit boards of directors. The parties in this case have presumed the business judgment rule will apply to MPRA. Other states have applied the business judgment rule to decisions of nonprofit corporations, explicitly or implicitly. The highest courts of Alabama, Hawaii, and South Dakota have done so, as have intermediate appellate courts of Colorado, New York, Ohio, South Carolina, Tennessee, and Wisconsin.² We find no case denying a nonprofit organization the protection of the business judgment rule.

[10] In addition to finding support in other jurisdictions for giving judicial deference to nonprofit corporate decisions, the

primary rationales for applying the business judgment rule in the for-profit context apply in the nonprofit context as well. Organizations are autonomous agents that should control their own destiny. *See Auerbach*, 419 N.Y.S.2d 920, 393 N.E.2d at 1000-01. Directors of nonprofits may take fewer risks than would be optimal if they were overly concerned about liability for well-meaning decisions. *See Daniel R. Fischel & Michael Bradley, The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 Cornell L.Rev. 261, 270 (1986). Additionally, courts are not well-equipped to scrutinize the decisions of a corporation; judges should not be caught in the middle of fighting factions of nonprofits any more than they should be thrust between dissatisfied shareholders and profit-seeking boards. *See id.* at 273. Therefore, we conclude that the boards of nonprofit corporations may receive the protection of the business judgment rule.

B. Special Litigation Committees

We turn now to consider whether a nonprofit board of directors that is not sufficiently *884 independent to decide whether to join a member's derivative lawsuit may establish a special litigation committee with authority to make the decision.³ Janssen claims a nonprofit may not appoint a special litigation committee because the Minnesota Nonprofit Corporation Act (Nonprofit Act) provides no such authority. Minn.Stat. § 317A.241 (2002). MPRA argues that the Nonprofit Act permitted them to appoint Murnane as its special litigation committee, and the district court agreed. The court of appeals concluded that the statute prohibited nonprofits from appointing special litigation committees. We agree with the district court.

[11] [12] [13] [14] Special litigation committees are made up of disinterested board members or individuals appointed by the board who are charged with informing themselves fully on the issues underlying the derivative suit and deciding whether pursuit of litigation is in the best interests of the corporation. *See, e.g., Houle v. Low*, 407 Mass. 810, 556 N.E.2d 51, 53 (1990); *Drilling v. Berman*, 589 N.W.2d 503, 505-07 (Minn.App.1999); *PSE & G*, 801 A.2d at 303. The key element is that the board delegates to a committee of disinterested persons the board's power to control the litigation. *Block, supra*, at 1689. A mere advisory role of the special litigation committee fails to bestow a sufficient legitimacy to warrant deference to the committee's decision by the court. If the board properly delegates its authority to act to the special litigation committee, the court will extend deference to the committee's

decision under the business judgment rule. *See* *Drilling*, 589 N.W.2d at 510; *Skoglund v. Brady*, 541 N.W.2d 17, 22 (Minn.App.1995); *Black v. NuAire, Inc.*, 426 N.W.2d 203, 211 (Minn.App.1988).

C. Minnesota Nonprofit Corporations Act

We look to the Nonprofit Act to determine whether MPRA had statutory authority to appoint its special litigation committee. The relevant part of the statute reads:

A resolution approved by the affirmative vote of a majority of the board may establish committees having the authority of the board in the management of the business of the corporation to the extent provided in the resolution. Committees are subject at all times to the direction and control of the board.

Minn.Stat. § 317A.241, subd. 1 (2002).

The first inquiry in statutory interpretation is whether the law is ambiguous. *See* Minn.Stat. § 645.16 (2002). If the words are clear and unambiguous, “the letter of the law shall not be disregarded under the pretext of pursuing the spirit.” *Id.* MPRA argues the statute unambiguously allows nonprofit boards to create independent committees. It maintains that the statute does not limit the types of committees that nonprofits can create in any way, thereby making litigation committees acceptable. In addition, MPRA posits that the phrase “subject at all times to the direction and control of the board” does not strip the committees of the independence necessary for the protection of the business judgment rule. Instead, it argues that “subject *885 * * * to” simply indicates a “possibility of control,” not a necessity of constant control.

Janssen also argues that the statute is unambiguous but urges a contrary meaning: a committee that must be “subject to” the “control” of the board cannot be sufficiently independent from the board to deserve the protection of the business judgment rule. Janssen also points to subdivision 5 of the statute, noting that a director cannot fulfill his or her standard of conduct by delegating authority to the board, as an indication that nonprofit directors have to retain control over all board committees.

The language in subdivision 1 indicating that committees must be subject to the board's control and direction could reasonably be interpreted to mean either that the board must control every move of the committees, or simply that the

board has a duty to oversee the work of the committees. The former interpretation would make true independence impossible, while the latter interpretation is flexible enough to allow for independent committees. As both parties' interpretations are plausible, we conclude the statute is not clear and free from all ambiguity.

If the words of a statute are not explicit, we interpret the statute's meaning by considering the intent of the legislature in drafting the law. Minn.Stat. § 645.16 (2002). There are three overarching considerations we consider in discerning legislative intent in this case: the context of the 1989 revision of the Nonprofit Act, contemporaneous legislative history, and consequences of a particular interpretation. *Id.* We will address each of these in turn. In addition, we presume that the legislature did not intend an absurd result or to violate the Constitution, and that it intended the entire statute to have effect and favor the public interest. Minn.Stat. § 645.17 (2002).

The 1989 revision of the Nonprofit Act was carried out eight years after the legislature enacted a wholesale revision of the Minnesota Business Corporation Act (Business Act), Minn.Stat. ch. 302A (2002), in 1981. *See* Minnesota Business Corporation Act of 1981, ch. 270, §§ 1-125, 1981 Minn. Laws 1141-1222. Shortly after the revised Business Act was adopted, the Minnesota State Bar Association organized a group to study the counterpart statute for nonprofits, and found it was outdated and unworkable, with many ambiguities. Hearing on H.F. 1203, H. Subcomm. Civil Law, 76th Minn. Leg., April 24, 1989 (audio tape) (comments of Kathleen Pontius). The act had not been revised since 1951, when the archetypal nonprofit in legislators' minds was a social club like the Jaycees or Rotary. Hearing on H.F. 1203, H. Subcomm. Civil Law, 76th Minn. Leg., April 24, 1989 (audio tape) (comments of Patrick Plunkett, president of Ramsey County Bar Ass'n). This original conception made the statute a poor fit for the growing number and variety of nonprofit organizations, and for the lawyers who served them. *Id.* A legislative committee drafted a new statute governing nonprofits, with three major sources: the Business Act, the ABA's Revised Model Nonprofit Act, and Minnesota's old nonprofit act. Hearing on H.F. 1203, H. Subcomm. Civil Law, 76th Minn. Leg., April 24, 1989 (audio tape) (comments of Rep. Thomas Pugh, bill's sponsor).

Minnesota Statutes § 317.241 was passed in the context of a wholesale revision of the Nonprofit Act. The legislature did not pass the statute to specifically address the committee structure of nonprofits *886 or their ability to control

derivative suits. We conclude that the legislature's purpose in revising the Minnesota Nonprofit Corporations Act in 1989 had nothing to do with special litigation committees, and sheds little light on our inquiry.

We next examine the contemporaneous legislative history to determine legislative intent. In reaching its decision that the legislature did not intend to empower nonprofit boards to create special litigation committees, the court of appeals emphasized the difference between the Business Act and the Nonprofit Act on this subject. The Business Act specifically says a board of directors may establish special litigation committees of one or more directors "to consider legal rights or remedies of the corporation and whether those rights and remedies should be pursued. Committees *other than special litigation committees* * * * are subject at all times to the direction and control of the board." Minn.Stat. § 302A.241, subd. 1 (2002) (emphasis added). The court of appeals was concerned that not only does the Nonprofit Act lack a specific provision for special litigation committees, it also does not exempt any committees from board control.

The comparison between the Business Act and the Nonprofit Act does not illuminate as much legislative intent as the court of appeals derived, however. The Nonprofit Act was passed eight years after the Business Act, making any attempt to infer meaning from a comparison between the two less convincing. A careful review of the available legislative history produced no discernible indication why the special litigation committee language was dropped. The absence of the special litigation language in the nonprofit statute could mean several things, including that the drafters did not think derivative suits were an issue for nonprofits and therefore did not address litigation committees in the Nonprofit Act.

[15] Given that little legislative intent concerning section 317A.241 can be inferred from either the purpose of the 1989 revision of the Nonprofit Act or the comparison with the Business Act, we are left with one remaining consideration in discerning legislative intent under Minn.Stat. § 645.16: the consequences of a particular interpretation. On this point it becomes clear that the district court reached the correct result. The district court noted that if nonprofit corporate boards are unable to establish independent committees whose informed business judgments merit deference from the courts, the judiciary would be forced to review the merits of every lawsuit brought by a member of a nonprofit corporation. Reviewing all derivative suits for nonprofit corporations would intrude on the authority of nonprofit boards, significantly tax our court system's limited resources,

and require judges to step significantly beyond their expertise. The district court concluded that "[s]uch a procedure-totally removing from the board of directors any control over litigation brought on behalf of the organization the board is supposed to govern-is clearly untenable." We agree. We see no reason to assume that the courts are better equipped to make business judgments about the merits of a lawsuit brought by a member of a nonprofit corporation than is a properly functioning board of directors whose duty it is to govern and promote the nonprofit corporation's best interests.

There are no characteristics of nonprofits that justify treating nonprofit and for-profit corporations differently in terms of their ability to delegate board authority to independent committees to review the *887 merits of derivative suits. There are nonprofits, like MPRA, that function very much like for-profit corporations and would benefit from the ability to weed out nuisance suits. In addition to pension funds, these nonprofits may include hospitals, schools, and homeowners associations.⁴ We are not alone in reaching this conclusion; two other states have used the business judgment rule when reviewing decisions by nonprofit litigation committees: *Finley v. Superior Court*, 80 Cal.App.4th 1152, 96 Cal.Rptr.2d 128, 132 (2000); *Miller v. Bargaheiser*, 70 Ohio App.3d 702, 591 N.E.2d 1339, 1343 (1990).

Refusing nonprofit corporations the ability to create special litigation committees is counter to our common law tradition as well. While statutes govern certain aspects of corporate life, including the initial incorporation, corporate litigation has been largely a creature of the common law. Derivative suits developed during the nineteenth century as an equitable means of protecting corporations and minority shareholders from fraudulent directors. Block, *supra*, at 1380. The first judicial opinions to apply the business judgment rule to the decision of a special litigation committee did not rely on statutory authority, but rather relied upon case law to determine whether a committee could terminate a shareholder lawsuit. Block, *supra*, at 1690-93.

[16] [17] A nonprofit corporation's power to appoint a special litigation committee, in the absence of a statutory prohibition, may also spring from the existence of corporate "incidental" powers to carry out corporate purposes. *Aiple v. Twin City Barge & Towing Co.*, 274 Minn. 38, 45, 143 N.W.2d 374, 378 (1966) (identifying corporate powers as being limited to "those actions expressly authorized by statute and such as are incidental thereto and necessary to carry them into effect"). It is now universally accepted in corporate

jurisprudence that corporations have the ability to exercise incidental or necessary powers:

Formerly, corporations were viewed as possessing only such powers as were specifically granted to them by the state. This grant of powers was found in the certificate of incorporation * * * or in the special statute granting a charter to the corporation.

* * * *

Today, in all the states, a corporation is deemed to possess all the powers of a natural person except those powers which are specifically forbidden to such corporations by the law. The old concept of a corporation as a bundle of only a few, specifically granted powers, has been replaced by the concept of a corporation as an artificial person, lacking only those powers which the law specifically denies to it.

Howard L. Oleck, *Non-Profit Corporations, Organizations, & Associations* § 168 (6th ed.1994); see also 13 William Meade Fletcher, et al., *Fletcher's Cyclopedic of the Law of Private Corporations* § 5963 (perm.ed., rev.vol.1984).

The untenable consequence of concluding the Nonprofit Act prohibits litigation *888 committees, in combination with the common law tradition favoring corporate control of derivative actions, leads us to conclude that nonprofit corporations have the power to create committees that are sufficiently independent to merit judicial deference. We hold the Minnesota Nonprofit Corporations Act does not prohibit corporations from appointing independent committees with the authority to decide whether the corporation should join a member's derivative suit.

II.

Having determined that nonprofit corporations have the power to create special litigation committees, the question remains whether Murnane deserved the deference of the business judgment rule. The court of appeals concluded that Murnane, as a special litigation committee, failed to meet the threshold test of independence and good faith, and ordered the lawsuit to proceed. We agree and affirm.

[18] All the state variations upon the business judgment rule as applied to committees reviewing litigation have two common elements. At a minimum, the board must establish that the committee acted in good faith and was sufficiently independent from the board of directors to dispassionately

review the derivative lawsuit. See, e.g., *Grimes v. Donald*, 673 A.2d 1207, 1219 (Del.1996); *Houle*, 556 N.E.2d at 59; *PSE & G*, 801 A.2d at 312; *Auerbach*, 419 N.Y.S.2d 920, 393 N.E.2d at 1000. A key factor in evaluating independence is whether the board delegates to a committee of disinterested persons the board's power to control the litigation. Block, *supra*, at 1689. A mere advisory role of the special litigation committee fails to bestow a sufficient legitimacy to warrant deference to the committee's decision by a court. Thus, we consider whether Murnane conducted his investigation with sufficient independence and good faith to deserve the deference of the business judgment rule. If not, the committee does not receive the court's deference and the derivative suit proceeds.

[19] In reviewing Murnane's first report, we conclude that the board failed to establish the independence and good faith of Murnane's investigation.⁵ We agree with the district court's determination that Murnane lacked independence because the MPRA's initial resolution restricted his factual investigation. Murnane was told to rely on facts developed by law firms that had been hired to represent MPRA in lawsuits about other legal issues. Additionally, Murnane's independence is suspect because his conduct suggests that he saw his role in conformance with his title: special counsel. Murnane did not talk to Janssen or their attorneys in investigating the suit and gave a conclusion that sounds like legal advice. That behavior belies MPRA's attempt to portray Murnane as a special litigation committee; instead MPRA hired Murnane to serve as its special counsel and he acted more like a legal advisor than a neutral decision maker.

*889 In addition, we conclude that Murnane did not engage in a good faith attempt to deduce the best interest of MPRA with respect to the litigation against Best & Flanagan. Murnane never interviewed Janssen or their attorneys, a fundamental task in reaching an informed decision about the merits of their complaints. Murnane also gave no indication that he had undertaken the careful consideration of all the germane benefits and detriments to MPRA that is indicative of a good faith business decision. Murnane opined that "the totality of the materials reviewed does not support a finding that Best & Flanagan committed legal malpractice in its handling of the MPRA affairs," and that "to spend money in the pursuit of a legal malpractice claim against Best & Flanagan would not be prudent use of the MPRA funds." The language of his conclusion hints that his decision was that of a special counsel evaluating the likelihood of a legal victory. But a much more comprehensive weighing and balancing of factors is expected in situations like this,

taking into consideration how joining or quashing the lawsuit could affect MPRA's economic health, relations between the board of directors and members, MPRA's public relations, and other factors common to reasoned business decisions. See *Auerbach*, 419 N.Y.S.2d 920, 393 N.E.2d at 1002. We conclude that Murnane's initial investigation of the derivative action instituted by Janssen against Best & Flanagan lacked the independence and good faith necessary to merit deference from this court.

[20] [21] Implicitly acknowledging the failures in its first resolution and investigation, the MPRA board urges us to consider the second resolution and improved investigation.⁶ We decline to do so. Generally, when the committee authorized with making a business decision for the corporation is found to lack the independence needed to grant summary judgment, or where the independence is uncertain, the derivative suit proceeds on its merits. See, e.g., *Hasan v. CleveTrust Realty Investors*, 729 F.2d 372, 380 (6th Cir.1984); *Will v. Engebretson & Co., Inc.*, 213 Cal.App.3d 1033, 1043-45, 261 Cal.Rptr. 868 (1989); *Lewis v. Fuqua*, 502 A.2d 962, 972 (Del.Ch.1985); *Davidowitz v. Edelman*, 153 Misc.2d 853, 858, 583 N.Y.S.2d 340 (Sup.Ct.1992). See also *Houle*, 556 N.E.2d at 58-60 (reversing summary judgment in favor of defendant board of directors and remanding for an evidentiary hearing before a judge regarding a committee member's independence, and noting that “[u]nless the defendant sustains its burden of proof as to both of those questions, the case should proceed to trial.”). The *Auerbach* court was blunt in its assessment of the consequences when proof of an investigation shows that the investigation is too restricted in scope or so shallow in execution as to constitute a pretext; such proof “would raise questions of good faith * * * which would *never* be shielded by that doctrine.” *Auerbach*, 419 N.Y.S.2d 920, 393 N.E.2d at 1003 (emphasis added).

The practice of allowing derivative suits to proceed to trial if a corporate board's initial attempt at a business decision fails the minimal requirements for judicial deference *890 is supported by the principles underlying the application of the business judgment doctrine. We strike a balance between allowing corporations to control their own destiny and permitting meritorious suits by shareholders and members by limiting a board of directors to one opportunity to exercise its business judgment. See, e.g., *Kaplan v. Wyatt*, 484 A.2d 501, 508 (Del.Ch.1984) (explaining that if the court determines the litigation committee failed the minimal review of the business judgment rule, the “court shall deny the motion for such reason and need go no farther, the result being that the

shareholder plaintiff may resume immediate control of the litigation”). If the courts allow corporate boards to continually improve their investigation to bolster their business decision, the rights of shareholders and members will be effectively nullified. We conclude that the district court erred in deferring MPRA's motion to dismiss and permitting the board to remedy defects in its first grant of authority to Murnane. We further conclude that Murnane failed to conduct his initial investigation with sufficient independence and good faith to deserve the deference of the business judgment rule and, therefore, hold that the district court erred when it granted MPRA's motion to dismiss the suit against Best & Flanagan.

Affirmed.

GILBERT, J., took no part in the consideration or decision of this case.

HANSON, Justice (concurring in part, dissenting in part).

Although I concur with the decisions that boards of nonprofit corporations are protected by the business judgment rule, that nonprofit corporations may avail themselves of that rule by appointing a special litigation committee to decide whether the corporation should join a members' derivative suit, and that Murnane may be viewed as a special litigation committee, I respectfully dissent on the decision to limit our review to Murnane's first report. The district court did not base its dismissal order on Murnane's first report because it concluded that procedural deficiencies precluded deference to Murnane's recommendations. The district court granted MPRA's motion to dismiss specifically on the basis of Murnane's second report, concluding that it was entitled to deference because it reflected an independent investigation that was conducted in good faith.

I find no authority to support the majority opinion's development of a “one strike you're out” rule for conducting an investigation of claims made in a derivative action. The cases cited by the majority stand only for the proposition that the derivative action proceeds to trial when a motion to dismiss, based on the recommendation of a special litigation committee, is denied. They do not address the question of whether such denial is with prejudice to later renewal or, more specifically applicable here, whether the district court has discretion to defer ruling on the motion to dismiss to allow further investigation. Drawing on the analogy to summary judgment motions generally, the federal decisions are unanimous in holding that the denial of a motion for summary judgment does not become the “law of the case”

so as to preclude the later grant of a renewed motion. *See, e.g., Paulson v. Greyhound Lines, Inc.*, 628 F.Supp. 888, 891 (D.Minn.1986), and cases cited in *891 10A Charles Alan Wright, Arthur R. Miller, & Mary Kay Kane, *Federal Practice and Procedure* § 2718 n. 6 (1998). This rule has been recognized by the Minnesota Court of Appeals in *Invest Cast, Inc. v. City of Blaine*, 471 N.W.2d 368, 370 (Minn.App.1991); *Brantner v. Fruehauf Corp.*, 1991 WL 10225 (Minn.App.). Even more to the point are those cases which hold that it is within the trial court's discretion to deny a motion for summary judgment without prejudice to it being renewed at a later time. *See Wright, Miller and Kane* § 2718 n. 5; 2 David F. Herr & Roger S. Haydock, *Minnesota Practice* § 56.11 (1998).

For these reasons, I would not limit review to Murnane's first report. Under these facts, where the deficiencies of the first report resulted from structural impediments imposed by the corporation upon the scope of the special litigation committee's investigation, I would conclude that the district court has discretion to defer (or to deny without prejudice) a motion to dismiss to allow the corporation an opportunity to remove those structural impediments.

Moreover, I would conclude that MPRA did remove the structural impediments to Murnane's investigation and that Murnane's second report did reflect sufficient independence and good faith to warrant dismissal.

In reaching this conclusion, I am persuaded that the deficiencies in Murnane's first report were not the product of any wrongdoing by Murnane, but instead were the necessary result of the structural impediments imposed by MPRA. That conclusion is confirmed by the majority opinion's review of Murnane's first report, which concludes that "Murnane lacked independence because the MPRA's initial resolution restricted his factual investigation." The resolution of the MPRA board, authorizing Murnane's continuing investigation after his first report, was appropriately broad:

Special Counsel is not required to assume as correct any portion of the previous reports prepared on behalf of the Board of Directors. Special Counsel is encouraged to solicit facts, argument and other input from the parties to the litigation in such manner and form as Special Counsel deems appropriate. Special Counsel is not limited in any way as to how to conduct his investigation or what material

he may consider. Special Counsel shall have complete independence and may undertake whatever good faith investigation he chooses.

The fault in Murnane's first report was cured by his further investigation and second report. Murnane interviewed Janssen and their attorneys, reviewed documents they provided and analyzed the arguments they presented. Murnane considered all of the germane benefits and detriments to MPRA of participating in the litigation.

There may be situations where an initial investigation by a special litigation committee is so tainted that an expanded investigation, at least by the same committee, could not cure the deficiencies in the required independence and good faith. For example, if there was evidence that Murnane had developed some bias or was committed to reach the same recommendation no matter what facts or arguments were brought to his attention, the second report would stand no better than the first. However, I see no evidence that this was the case.

Finally, I cannot agree with the majority opinion's view that Murnane's legal evaluation of the likely outcome of the derivative action somehow discredited the independence or good faith of his investigation. *892 Although Murnane, as a special litigation committee, was expected to exercise the "business judgment" of a board of directors, that business judgment must be applied to the merits of the derivative action. The best interests of MPRA depend upon an objective assessment of whether the likely outcome of the derivative action justifies the expenditure of time, effort and collegiality. In such a cost-benefit analysis, the potential benefit depends directly upon the likelihood of a favorable outcome in the litigation-the less likely a favorable outcome, the less benefit.

Murnane's report concludes that there would be no benefit to participating in the derivative action-"the association would be unsuccessful in prosecuting a cause of action against Best & Flanagan, Brian Rice and Charles Berquist"-but that the cost would be significant, despite the willingness of Janssen's counsel to proceed on a contingent fee basis-"the ongoing viability of the association and a harmonious relationship between its board of directors and legal counsel" would be adversely affected. This is precisely the type of business judgment that a special litigation committee is expected to make and, when made in good faith by a committee that is independent of the corporation's board, it is entitled to deference by the court. Accordingly, I would reverse the court

of appeals and conclude that the district court did not err when it dismissed the derivative action based on Murnane's second report and recommendation.

BLATZ, Chief Justice (concurring in part, dissenting in part).

I join in the concurrence and dissent of Justice Hanson.

Footnotes

- 1 For a thorough discussion of the rationale behind judicial deference to business decisions, see Peter V. Letsou, *Implications of Shareholder Diversification on Corporate Law and Organization: The Case of the Business Judgment Rule*, 77 Chi.-Kent L.Rev. 179, 181-82 (2001); Eric W. Orts, *The Complexity and Legitimacy of Corporate Law*, 50 Wash. & Lee L.Rev. 1565, 1588 (1993); Ralph K. Winter, *On 'Protecting the Ordinary Investor,'* 63 Wash. L.Rev. 881, 895 (1988); Daniel R. Fischel & Michael Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 Cornell L.Rev. 261, 270-71 (1986).
- 2 See *Fairhope Single Tax Corp. v. Rezner*, 527 So.2d 1232, 1236 (Ala.1987); *Chun v. Bd. of Trustees of the Employees' Ret. Sys. of the State of Hawaii*, 87 Hawai'i 152, 952 P.2d 1215, 1226-27 (1998); *Mahan v. Avera St. Luke's*, 621 N.W.2d 150, 154 (S.D.2001); *Rywalt v. Writer Corp.*, 34 Colo.App. 334, 526 P.2d 316, 317 (1974); *Scheuer Family Foundation Inc. v. 61 Associates*, 179 A.D.2d 65, 582 N.Y.S.2d 662, 663 (1992); *Solomon v. Edgewater Yacht Club, Inc.*, 35 Ohio Misc.2d 1, 519 N.E.2d 429, 431 (Mun.1987); *Dockside Ass'n, Inc. v. Detyens*, 291 S.C. 214, 352 S.E.2d 714, 716 (App.1987); *Burke v. Tennessee Walking Horse Breeders' & Exhibitors' Ass'n*, 1997 WL 277999, *9 (Tenn.Ct.App.1997); *John v. John*, 153 Wis.2d 343, 450 N.W.2d 795, 801-02 (Wis.Ct.App.1989).
- 3 Both Janssen and MPRA accepted the premise that the full MPRA board was not independent enough to merit judicial deference as a decision maker, and made no arguments about deferring to the decision of the board of directors to accept Murnane's report. Thus, we are focusing on whether Murnane's decision is entitled to deference.
- 4 See Peter Frumkin & Alice Andre-Clark, *Nonprofit Compensation and the Market*, 21 U. Haw. L.Rev. 425, 427 (1999) (describing a lawsuit by a trustee of an educational organization against another trustee); *Miller v. Bargaheiser*, 70 Ohio App.3d 702, 591 N.E.2d 1339, 1341 (1990) (involving a derivative suit on behalf of a nonprofit hospital); *Dockside Ass'n*, 352 S.E.2d at 714 (involving a suit against a property association).
- 5 We do not adopt a particular version of the business judgment rule for use with Minnesota nonprofit organizations today. Because we hold that Murnane's investigation failed the most minimal version of a business judgment rule, requiring that a litigation committee act in good faith, with independence, we need not reach the question of whether a more exacting standard of judicial review may be appropriate for nonprofit corporations than in the case of for-profit corporations. The members of nonprofits are not akin to diversified shareholders-any risk sustained by them cannot necessarily be spread among their other investments. Nor can they necessarily protect themselves by taking their assets elsewhere.
- 6 We note that the district court could have deferred the motion in order to simply supplement the record. However, there is a marked difference between allowing a corporation to supply documents that better indicate the process it employed in reaching its business decision, and allowing the corporation to reconstitute its litigation committee and revamp its investigation. The former is permitted by a judge's authority to continue a summary judgment motion to more fully develop the record; the latter is not supported by the principles underlying the application of the business judgment doctrine.

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UNPUBLISHED OPINION. CHECK
COURT RULES BEFORE CITING.

Court of Chancery of Delaware.

Craig LONDON and James Hunt, individually
and derivatively on behalf of MA Federal, Inc.,
d/b/a iGov, a Delaware corporation, Plaintiffs,

v.

Michael TYRRELL, Patrick Neven,
and Walter Hupalo, Defendants,
and

MA Federal, Inc., d/b/a iGov, a Delaware
corporation, Nominal Defendant.

Civil Action No. 3321-CC. | Submitted:
Dec. 18, 2009. | Decided: March 11, 2010.

Attorneys and Law Firms

David A. Jenkins, Michele C. Gott, and Kathleen M. Miller,
of Smith, Katzenstein & Furlow LLP, Wilmington, Delaware,
Attorneys for Plaintiffs.

Elizabeth M. McGeever and J. Clayton Athey, of Prickett,
Jones & Elliott, P.A., Wilmington, Delaware; of Counsel:
John C. Hayes, Jr. and Kimberly J. Jandrain, of Nixon
Peabody LLP, Washington, District of Columbia, Attorneys
for Defendants.

Art C. Aranilla, of Marshall, Dennehey, Warner, Coleman
& Goggin, Wilmington, Delaware, Attorneys for Nominal
Defendant.

Opinion

CHANDLER, Chancellor.

*1 After a four-month investigation of plaintiffs' claims in this derivative action, a special litigation committee (the "SLC") formed by nominal defendant iGov has recommended dismissal of plaintiffs' suit. I deny the SLC's motion to dismiss because there are material questions of fact regarding (1) the SLC's independence, (2) the good faith of its investigation, and (3) whether the grounds upon which it recommended dismissal of this lawsuit are reasonable. Accordingly, plaintiffs may continue to pursue this action.

I. FACTS

This dispute springs from the approval and implementation of an equity incentive plan on January 30, 2007 (the "2007 Plan") by defendants in their role as iGov directors. To better understand the context of that approval, I begin our review of the facts at an earlier date and tell the story chronologically.

A. iGov Begins to Reinvent Itself and Wins the TACLAN Contract

In 1996, plaintiffs Craig London and James Hunt, defendants Patrick Neven and Walter Hupalo, and others founded MA Federal, Inc., which does business as iGov ("iGov" or the "Company"). iGov is a government contracting firm that initially focused on the reseller market for information technology hardware, primarily selling to federal military and civilian agencies. After nine years in the low margin, highly competitive reseller market, however, the Company decided to change its focus from product sales to the higher-margin government services market. This shift in focus, which occurred in 2005, was driven by management's view that iGov could not sustain itself over the long term in the reseller business because of increasing competition from larger players.

In October 2005, iGov won its first government services contract with the United States Special Operations Command. iGov refers to this agreement as the TACLAN contract, which stands for Tactical Local Area Network Production. TACLAN units are portable centers capable of coordinating communications for special operations forces all over the world. Under the TACLAN contract, iGov was to engineer, manufacture, test, train, and support TACLAN units, something it had little to no previous experience doing. Plaintiffs' complaint alleges that the TACLAN contract was a 5-year, \$300 million competitive contract that would likely provide iGov with a substantial stream of high-margin services revenue. The \$300 million figure in the TACLAN contract was an expenditure ceiling that could not be exceeded without government authorization, not a guarantee that the government would actually spend \$300 million. iGov's ongoing performance under the TACLAN contract would largely determine how much the government spent. iGov's gross profit margins on the TACLAN contract would, of course, depend on how well iGov managed its costs. Thus, profitability under the TACLAN contract was driven by the volume of government orders and iGov's cost management.

B. Tyrrell is Hired to Help Solve iGov's Financial Difficulties

*2 iGov incurred substantial non-recurring expenses when it began to reinvent itself as a service provider in 2005. These expenses placed iGov in a financially precarious position. In an effort to lift the Company out of its fiscal doldrums, iGov's CEO, Neven, sought help from a professional "turn-around expert" called Tatum LLC. Tatum provided Michael Tyrrell for the job and Tyrrell began to work for iGov as a consultant in September 2005.

As a result of the financial difficulties iGov experienced in 2005, its relationship with its primary lender soured. By May 2006, iGov was searching for a new lender to supply it with an operating line of credit. Textron Financial ("Textron") emerged as a promising source of credit. To induce Textron to extend the needed credit, Tyrrell kept Textron apprised of iGov's financial condition on an ongoing basis. Tyrrell created and approved the financial information transmitted to Textron, which included monthly income statements, balance sheets, and forecasts for fiscal years 2006 and 2007.

C. The First Textron Forecast and the DHS Contract

On May 4, 2006, Tyrrell sent Textron an email with a fiscal year 2007 ("FY07") forecast reflecting an EBITDA of approximately \$3.5 million (the "First Textron Forecast"). In the email Tyrrell explained that the First Textron Forecast assumed iGov "will be successful in winning the Department of Homeland Security (DHS) contract."¹ The DHS contract is a competitive contract under which multiple vendors compete to provide information technology hardware to the various agencies directed by the DHS. Tyrrell included \$10 million in DHS contract revenue in the First Textron Forecast. Tyrrell explained to Textron that he was normally "very hesitant to put unawarded contracts into [iGov] forecasts" but nevertheless included \$10 million in DHS contract revenue because he had "been pretty conservative in other areas" of the First Textron Forecast and felt that \$10 million was "a reasonable figure."² He further noted that if iGov was awarded the DHS contract it would probably yield \$30-50 million in first year business. Other important line items in the First Textron Forecast included \$6 million in revenue for iGov's Air Force unit, \$35 million in revenue for GCG (an iGov subsidiary), and \$195 million in revenue for the TACLAN contract.

D. Tyrrell Becomes CFO after Textron Financing is Obtained

By July 2006 negotiations with Textron were nearing completion. To finalize a \$12 million line of credit, London was asked to execute a personal guarantee required by Textron's lending guidelines. Defendants allege that on the due date of the guarantee, London demanded an employment contract in exchange for signing. Apparently Neven did not look favorably on this demand and decided to remove London from his position as CFO in response. Shortly thereafter, Neven asked Tyrrell to become iGov's full-time CFO. Neven signed the personal guarantee and the \$12 million line of credit was obtained.

E. The Second Textron Forecast

*3 On August 15, 2006, Tyrrell sent Textron an updated FY07 forecast showing an EBITDA of roughly \$3 million (the "Second Textron Forecast"). The major differences between the Second Textron Forecast and the First Textron Forecast were that projected revenues for the GCG subsidiary were lowered to \$25 million and projected revenues from the TACLAN contract were lowered to \$183 million.³

F. The Original Chessiecap Forecast

At some point in 2006 defendants decided that it would be advisable to implement the 2007 Plan for the benefit of key members of management. Defendants caused iGov to retain Chessiecap Securities, Inc. ("Chessiecap") to value iGov stock for purposes of setting the exercise price of options under the 2007 Plan. Plaintiffs complaint alleges that defendants "secretly decided to implement [the 2007 Plan] at an unfair price to benefit themselves at the expense of the other stockholders."⁴

Chessiecap was to perform a valuation of iGov as of July 31, 2006. To support the valuation, Tyrrell sent Chessiecap a FY07 forecast on August 23, 2006 that showed an EBITDA of roughly \$3 million (the "Original Chessiecap Forecast"). The Original Chessiecap Forecast was identical to the Second Textron Forecast.⁵

G. The Revised Chessiecap Forecast and the Final Valuation

On October 2, 2006, Chessiecap completed its Draft Valuation, concluding that iGov equity was worth \$5.5 million. After reviewing the Draft Valuation, Tyrrell sent an

email to Chessiecap expressing his view that it was “probably on the high side.”⁶ Tyrrell gave various reasons for this view. Three of these reasons are of note. First, Tyrrell asserted that the projected \$10 million in revenue (and associated costs) for FY07 from the DHS contract should not be considered in the valuation because the DHS contract had not been formally awarded. Second, Tyrrell asserted that the projected \$25 million in revenues (and associated costs) from the GCG subsidiary for FY07 should be removed because GCG would be closed before year-end. Third, Tyrrell asserted that most of the projected \$6 million in revenues and associated costs from the Air Force unit for FY07 should be removed because iGov was also likely to close down that unit before year-end. On October 18, 2006, Tyrrell sent Chessiecap a revised forecast that eliminated the revenues and expenses from these three line items.⁷ This updated FY07 forecast showed an EBITDA of \$1.8 million (the “Revised Chessiecap Forecast”), 40% less than the \$3 million EBITDA reflected in the Original Chessiecap Forecast.

Plaintiffs' complaint asserts that in preparing the Revised Chessiecap Forecast, Tyrrell made material changes based on developments that had occurred after the July 31, 2006 valuation date. For example, iGov did not announce that it was going to close down GCG until October 4, 2006, but Tyrrell incorporated this development into the Revised Chessiecap Forecast. Thus, Chessiecap's Final Valuation, of which more will be said momentarily, was not strictly an evaluation based on what was known or anticipated as of July 31, 2006. According to plaintiffs, this is problematic because, although the Revised Chessiecap Forecast accounted for negative developments that occurred after July 31, 2006, it did not reflect positive developments that occurred after the valuation date. Specifically, plaintiffs allege that iGov had been awarded a \$7 million contract with the U.S. Patent and Trademark Office (“PTO”) in September 2006, but this was not reflected in the Revised Chessiecap Forecast. Also, plaintiffs allege that by October 2006 the TACLAN contract was generating higher profits than management had originally expected but this was ignored when preparing the Revised Chessiecap Forecast.⁸

*4 Plaintiffs contend that the Revised Chessiecap Forecast was never disclosed to Textron. Plaintiffs also allege that the Revised Chessiecap Forecast was never used by the Company in managing its business. Rather, the Revised Chessiecap Forecast was purposely designed to suppress the value of the Company and was only used by Chessiecap.

On October 31, 2006, Chessiecap certified its Final Valuation of iGov, which was partially based on the Revised Chessiecap Forecast. The Final Valuation placed the value of iGov equity at \$4.7 million, approximately 15% lower than Chessiecap's Draft Valuation of \$5.5 million. At the time the Final Valuation was issued, Chessiecap did not calculate the fair market value per share of iGov equity. This was done later to support approval of the 2007 Plan on January 30, 2007.

H. The Third Textron Forecast

After the Final Valuation was issued, Tyrrell continued to update Textron on iGov's finances. Tyrrell's updates portrayed a brighter outlook on the EBITDA front than had been communicated to Chessiecap in the Revised Chessiecap Forecast. For example, on December 1, 2006, Tyrrell resent the Second Textron Forecast to a different Textron employee. In the accompanying email Tyrrell explained that iGov was in the process of further updating its FY07 forecast and that he expected the revised forecast to be “just as good, if not better.”⁹

On December 8, 2006, as promised, Tyrrell sent Textron an updated FY07 forecast that showed an EBITDA of approximately \$3.1 million (the “Third Textron Forecast”). The individual line items in the Third Textron Forecast differed in many respects from the Second Textron Forecast, though the overall EBITDA was substantially the same.¹⁰ The important factual consideration for present purposes is the many respects in which the Third Textron Forecast differed from the Revised Chessiecap Forecast. For instance, the Third Textron Forecast included approximately \$1.9 million in revenue for the Air Force unit (as opposed to \$900,000), \$950,000 in revenue for GCG (as opposed to \$0), and \$15 million in revenue for the DHS contract (as opposed to \$0).¹¹ The Third Textron Forecast also reflected \$7 million higher projected revenues for the Navy unit. Although TACLAN revenues were projected to be roughly \$8 million lower, the projected gross profit from the TACLAN contract was \$2 million higher. The net result of all these changes was a stark difference in EBITDA between the Third Textron Forecast and the Revised Chessiecap Forecast: \$3.1 million versus \$1.8 million.

I. The Tyrrell Baseline Forecast

Defendants allege that in December 2006 Tyrrell developed three additional forecasts, presumably for internal purposes. Each forecast was based on different assumptions about

the future and accordingly yielded different results. The “Baseline Forecast” showed an EBITDA of \$2.1 million (the “Tyrrell Baseline Forecast”). It was nearly identical to the Third Textron Forecast. The one major difference was that the \$15 million in revenue from the DHS contract and associated expenses were eliminated from the Tyrrell Baseline Forecast. The gross profit margin on the DHS contract accounted for most of the \$1 million difference in EBITDA between the two projections.¹² In addition to the Tyrrell Baseline Forecast, Tyrrell allegedly developed a \$4.3 million EBITDA forecast which he dubbed the “Better Forecast” and a \$6.1 million EBITDA forecast which he dubbed the “Stretch Forecast.” From the record, it is not entirely clear what, if anything, these latter two forecasts were used for.

J. iGov's Internal Forecasts Remain Higher than the Revised Chessiecap Forecast

*5 In addition to showing that the First, Second, and Third Textron Forecasts were decidedly more positive than the Revised Chessiecap Forecast, plaintiffs proffered evidence that iGov continued to project a FY07 EBITDA of approximately \$3-4 million internally *after* Chessiecap had been given the Revised Chessiecap Forecast showing an EBITDA of only \$1.8 million. For example, in December 2006, a strategic management plan prepared by Hupalo included a goal to “exceed \$3 million in EBITDA by year-end FY#07.”¹³ On December 15, 2006, Neven represented in an email to a stockholder that “iGov is financially healthy again, ... we expect to be at \$150 million this coming year with an EBITAD [sic] of \$3 million ...”¹⁴ On January 7, 2007, Tyrrell sent the Third Textron Forecast to the incoming CFO Rich Marksberry¹⁵ and informed him that it was “the baseline case forecast for iGov for FY07” and that iGov was “currently updating a version that shows EBITDA of over \$4 million, which we think is possibly achievable this year.”¹⁶ On January 12, 2007, Tyrrell made a presentation at a business development strategy meeting that projected FY07 EBITDA at over \$4 million.¹⁷ And on February 10, 2007, Tyrrell sent an email to a strategic consultant representing that “our working internal forecast shows EBITDA of \$3MM.”¹⁸

K. Plaintiffs Object to the Final Valuation

On December 22, 2006, Tyrrell became concerned that nearly half a year had passed since the July 31, 2006 valuation date on Chessiecap's Final Valuation. The 2007 Plan was taking longer to implement than defendants had anticipated. Tyrrell contacted Chessiecap and asked them if the Final Valuation

needed to be updated “since our 2006 valuation is dated July 31, 2006 and the stock options will not be given until the end of next month ... ?”¹⁹ Chessiecap replied that the Final Valuation was good for one year, unless significant events had occurred that would materially change the financial prospects of the Company.²⁰

On December 29, 2006, plaintiffs were provided a copy of Chessiecap's Final Valuation placing iGov's equity value at \$4.7 million. After reviewing the Final Valuation plaintiffs requested copies of the information Chessiecap had relied on. Among other things, they were given the Revised Chessiecap Forecast. In the meantime, on January 7, 2007, Tyrrell sent an email to iGov management regarding a proposal to purchase London's shares for \$4 per share, plus a “kicker” down the road if iGov was sold. In the email, Tyrrell expressed the view that “since [iGov's] valuation is a few months old, [iGov] will probably have to have it updated and the valuation will likely be higher than \$4.7 million....”²¹ Tyrrell concluded that the \$4 per share figure would still be fair to London because the number of iGov's issued shares was soon to be increased by the 2007 Plan. On January 16, 2007, however, after reviewing the Revised Chessiecap Forecast, London objected to iGov relying on Chessiecap's Final Valuation for purposes of the 2007 Plan because he felt the information upon which the Final Valuation was based was stale and inaccurate. The next day, Hunt, who also believed the Final Valuation was unreliable, made an offer to buy all of Neven's stock at \$28 per share. Hunt later made the same offer to other shareholders, apparently with the design of purchasing enough shares to gain voting control of iGov.

L. Plaintiffs are Removed from the Board

*6 At this point, in a narrative much belabored with disorienting descriptions of multiple financial forecasts, the human controversy begins. Plaintiffs London and Hunt comprised half of the iGov board on January 16 and 17, when it became clear that they disagreed with using Chessiecap's Final Valuation in its then-current form. The other half of the iGov board consisted of defendants Neven and Hupalo. Collectively, Neven and Hupalo owned 42.5% of iGov's voting stock. On January 19, 2007, Neven and Hupalo teamed up with iGov officer and shareholder Jack Pooley, the three of them collectively owning 50.1% of iGov's voting stock, and executed written stockholder consents removing plaintiffs from the board. At the same time, they elected Tyrrell to the board. Thus, after January 19, 2007, defendants made up the entire iGov board.

M. The 2007 Plan is Adopted

On January 30, 2007, the core series of events occurred that gave rise to this litigation. To address Hunt's \$28 per share offer, defendants engaged Chessicap to prepare an addendum to its Final Valuation. In the addendum, dated January 30, 2007, Chessicap opined that Hunt's offer did not affect or change Chessicap's opinion that iGov's equity value was \$4.7 million. The addendum stated that Hunt's offer was conditioned on his receiving enough shares to own a majority of iGov's voting stock and that this excluded Hunt's offer "from any consideration in Chessicap's valuation of the Company, which was premised upon privately-held, minority discounted stock."²² The addendum then determined for the first time the share price of iGov stock, concluding that the fair market value per share as of July 31, 2006 was \$4.92. In calculating this per-share price, the addendum incorrectly included 65,000 shares and 300,000 options that were not outstanding as of the July 31, 2006 valuation date. These shares and options were not approved until January 30, 2007 (the day the addendum was issued) as part of the 2007 Plan, which I will describe in detail momentarily. Plaintiffs assert that defendants knew these shares and options were inappropriately included in Chessicap's per share calculation, but ignored the purported error as it resulted in a lower value that benefitted defendants.

Defendants also held a special meeting of the iGov board on January 30, 2007. As Hunt, the former chairman, had just been removed as a director, the first order of business was appointing a new chairman. Neven was appointed by unanimous consent and he then called the meeting to order. During the meeting Tyrrell was named President, Chief Operating Officer, and Treasurer of iGov and Marksberry was named CFO.

The primary purpose of the meeting was to consider the 2007 Plan. Under the 2007 Plan, 300,000 stock options were to be issued to various directors and senior executives. Of the 300,000 options, Tyrrell was to receive 80,000, Neven 50,000, and Hupalo 50,000. Thus, collectively, defendants were to be given 60% of the options granted under the 2007 Plan. In addition, the 2007 Plan contemplated the sale of 65,000 shares of stock to Tyrrell. In contrast, plaintiffs were not to be given any options or shares under the 2007 Plan, presumably because they had been removed from their director and management positions.

*7 The 2007 Plan provided that the exercise price of the options could not be less than 100% of the fair market value of iGov common stock *on the date the options were granted* and that the sale of shares to Tyrrell would be at their fair market value *on the date of sale*. Defendants unanimously voted as directors to approve the 2007 Plan. Defendants simultaneously adopted \$4.92 per share as the fair market value of iGov shares on January 30, 2007 based on Chessicap's Final Valuation, dated July 31, 2006, and the associated addendum. Before approving the 2007 Plan, Tyrrell represented to Chessicap that no material change had occurred and so it was still appropriate, in his view, to rely on the Final Valuation.²³ All defendants then implicitly accepted that no material change had occurred by approving \$4.92 per share as the fair market value. Tyrrell purchased his 65,000 shares the next day.

Plaintiffs allege that the 2007 Plan was designed to substantially reduce their ownership interests in iGov and increase defendants' interests to a level that would permit defendants to entrench themselves as iGov directors and managers. In support of this theory, plaintiffs assert that implementation of the 2007 Plan immediately reduced their collective ownership interests from 44% to 40%. On a fully diluted basis, the 2007 Plan allegedly reduced plaintiffs' collective ownership interests from 42.3% to 28.7%. At the same time, the 2007 Plan allegedly increased defendants' collective ownership interests from 50.1% to 54.1% and, on a fully diluted basis, defendants' collective ownership interests allegedly increased from 48.2% to 54.2%.²⁴

As we have discussed, plaintiffs contend that defendants manipulated the Final Valuation by excluding positive developments which occurred after July 31, 2006 from the Revised Chessicap Forecast. Plaintiffs also contend that defendants wrongfully declined to update either the Revised Chessicap Forecast or the Final Valuation before approving the 2007 Plan, falsely representing that no material change had occurred between July 31, 2006 and January 30, 2007. Plaintiffs point to three specific developments which were purportedly ignored. First, the \$7 million PTO contract had been awarded on September 29, 2006, but was not reflected in the Revised Chessicap Forecast or the Final Valuation. Second, on December 20, 2006, iGov received a pre-award notice that it had been selected as one of the vendors under the DHS contract, putting the Company one step further towards realizing DHS revenue in 2007, but no such revenues were included in the Revised Chessicap Forecast or the Final Valuation. And third, by January 30, 2007,

iGov was aware that the TACLAN contract was performing better than expected but did not have Chessiecap update its Final Valuation to reflect the increased profitability of the TACLAN contract.²⁵

Other features of the 2007 Plan should be noted to tell the full story. For starters, the 2007 Plan replaced an existing equity incentive plan at iGov. In February 2001, the iGov board had approved the 2000 Stock Option and Incentive Plan (the "2000 Plan"). The 2000 Plan gave iGov the power to grant stock options to various officers, directors, consultants, and other employees at an exercise price of \$5.00 per share. No formal valuation appears to have supported the \$5.00 strike price, though options were granted to employees and exercised at this price. A few years later, on February 26, 2003, London proposed that Neven, Hupalo, and London should each be awarded 50,000 options under the 2000 Plan at an exercise price of \$1.25 per share as compensation for their services to iGov. The board approved London's proposal, but these options were never exercised. In fact, there is a dispute over whether they were ever actually granted. Evidently, in 2005 iGov's auditors noted that the marked difference between the \$5.00 and \$1.25 strike prices under the 2000 Plan had not been properly accounted for, and would give rise to a substantial charge on the financial statements if iGov was determined to leave the \$1.25 options in place.

*8 Defendants contend that the 2007 Plan was an effort to revamp the 2000 Plan, which was imperfectly structured, and to replace the \$1.25 options granted to Neven, Hupalo, and London. Accordingly, defendants assert that in adopting the 2007 Plan Neven and Hupalo gave up options with a strike price of \$1.25 for options with a strike price of \$4.92, sacrificing personally for the good of the Company. Plaintiffs, on the other hand, contend that the \$1.25 options were never actually granted and so Neven and Hupalo gave up nothing. I will explore this dispute later. For now, I simply note that the 2007 Plan as adopted explicitly superseded the 2000 Plan (at least to the extent it was legitimate).

The 2007 Plan also gave Neven and Tyrrell the collective authority to grant up to 25,000 options to the new CFO, Marksberry, at an exercise price equal to the fair market value of the shares *on the date of the grant*. If Neven and Tyrrell both wished to grant Marksberry these options, the 2007 Plan required them to do it by April 15, 2007. Marksberry did not receive a grant of options by that date and the delegated authority to Neven and Tyrrell expired.

Finally, the 2007 Plan provided that stockholder approval would be obtained within twelve months. Plaintiffs, who remained stockholders in iGov after their removal from the board, allege that they never voted on the 2007 Plan.²⁶

N. The DHS Contract is Awarded

A few months later, in March 2007, iGov announced that it had formally been awarded the DHS contract. This placed the Company firmly in the position of being able to realize DHS revenues in 2007. The amount of DHS revenues to be realized, of course, would depend on how well iGov performed under the DHS contract relative to the other approved vendors. As we have seen, Tyrrell had excluded DHS revenues from the Revised Chessiecap Forecast because the DHS contract had not been formally awarded.

O. Marksberry is Granted 25, 000 Shares

Despite having formally secured the DHS contract, on May 30, 2007, defendants approved the grant of 25,000 options to Marksberry at a strike price of \$4.92 per share.²⁷ Apparently cognizant that ten months had passed since the date of Chessiecap's Final Valuation, defendants explicitly stated in the board resolution approving the grants that "there ha[d] been no material changes affecting the Company's financial operations or prospects which would affect [the Final] Valuation since the date of its last determination of Fair Market Value."²⁸ Thus, in approving the option grants to Marksberry, defendants relied on Chessiecap's advice that the Final Valuation was good for one year absent any material changes and on its own determination that no material changes had occurred between July 31, 2006 and May 30, 2007. Defendants made this determination even though the DHS contract had been formally awarded in the interim.

P. Plaintiffs' Suit

After the 2007 Plan was approved, plaintiffs made a books and records request under 8 Del. C. § 220. The ground for the request was plaintiffs' objection to iGov using Chessiecap's Final Valuation as the basis for the \$4.92 per share strike price. Plaintiffs also engaged the McLean Group, a valuation firm, to conduct separate valuations of iGov's equity as of October 31, 2006 and December 31, 2006 (the "McLean Valuations"). In performing the McLean Valuations, McLean used the Second Textron Forecast²⁹ rather than the Revised Chessiecap Forecast. McLean noted that Chessiecap's Final Valuation incorrectly included in its option-pricing model

the 300,000 options and the 65,000 shares approved by the 2007 Plan, rather than the outstanding 745,000 shares that actually existed as of July 31, 2006. The McLean Valuations placed the per share value of iGov equity at \$13.32 on October 31, 2006 and \$15.45 on December 31, 2006. The McLean Valuations were sent to iGov on September 18, 2007, along with McLean's separate critique of Chessiecap's Final Valuation.

*9 While the McLean Valuations were being conducted, iGov expanded the size of its board from three members to five. In August 2007, Vincent Salvatori and John Vinter became iGov directors. Both men were first approached by Tyrrell and both had connections to him, which I will discuss at some length later. Both men also had extensive experience in government contracting that understandably made them attractive candidates for iGov's board.

On October 31, 2007, after attempts to resolve the dispute failed, plaintiffs filed their complaint. The counts in the complaint are characterized as derivative and individual, alleging harm to iGov as a company and to plaintiffs in their personal capacity. In February 2008, the complaint was amended in response to defendants' motion to dismiss.

The amended complaint contains three counts. Count I is a derivative claim for breach of fiduciary duty alleging defendants failed to honor their duties of care and loyalty. With regards to the duty of loyalty, Count I alleges that defendants materially misrepresented iGov's business prospects to Chessiecap in order to ensure a low valuation so that they could personally obtain iGov stock at an artificially low price. Count I also alleges that defendants breached their duty of loyalty by approving the 2007 Plan with the intent that it would firmly entrench them in their positions as directors and managers of iGov. Regarding the duty of care, Count I alleges that defendants failed to consider all material information available to them in determining the value of iGov stock for purposes of the 2007 Plan. In that vein, Count I alleges that defendants knew when they approved the 2007 Plan that Chessiecap's Final Valuation was based on stale and inaccurate information and was therefore an inappropriate tool for determining the fair value of iGov shares as of January 30, 2007. Count I also alleges that defendants had even more reason to believe the Final Valuation was outdated by May 30, 2007 because the DHS contract had been definitively awarded by that date, but defendants still declined to have the Final Valuation updated. Count II is a request for relief rather than a cause of action. It seeks rescission of the option grants to defendants and the stock sale to Tyrrell based on the

breaches of fiduciary duty described in Count I. Count III is characterized by plaintiffs as an individual claim, the personal harm being that defendants improperly diluted plaintiffs' ownership interests by implementing the 2007 Plan, thereby expropriating economic value and voting power from them. For their part, defendants contend that Count III is a derivative claim.

Q. iGov Forms a Special Litigation Committee after its Motion to Dismiss is Denied

After plaintiffs' complaint was amended, defendants again filed a motion to dismiss on several grounds, including plaintiffs' failure to make a demand on the board before filing suit. In my June 24, 2008 Opinion, I found that plaintiffs' complaint "easily survived" defendants' motion to dismiss; demand being excused because a majority of the board was interested in the transaction.³⁰ Thereafter, on November 21, 2008, the iGov board voted to form a two-member SLC comprised of Salvatori and Vinter to consider whether it was in iGov's best interest to pursue the derivative claims in plaintiffs' complaint.

*10 After its formation, the SLC obtained advisors. In February 2009 the SLC engaged Blank Rome LLC as independent counsel and in March 2009 the SLC engaged Stout Risius Ross ("SRR") as its independent financial advisor.

From April 2009 to July 2009 the SLC conducted its investigation. Discovery was stayed during this time. In conducting the investigation the SLC interviewed twelve witnesses and reviewed relevant documentation produced by the parties, iGov, Textron, Chessiecap, McLean, and others, including the documents provided to plaintiffs in response to their § 220 action. To inform their investigation, the SLC sought counsel's advice as to the legal principles that determine whether defendants complied with their fiduciary duties.

During the investigation, the SLC charged SRR with two tasks. First, SRR was instructed to perform independent valuations of iGov as of October 31, 2006 and as of January 30, 2007 (the "SRR Valuations"). The SLC required SRR to complete the SRR Valuations without reviewing the work done by Chessiecap and McLean, presumably to ensure that SRR would not be influenced by any previous valuation work performed. The SLC determined that October 31, 2006 was an appropriate valuation date because it believed that Chessiecap's Final Valuation was essentially current as of

October 31, 2006, despite being dated July 31, 2006.³¹ The SLC determined that January 30, 2007 was an appropriate date for more obvious reasons; it was the date the challenged 2007 Plan was adopted. I will discuss the SRR Valuations at greater length later but for now I note that the FY07 EBITDA forecast SRR used was the Tyrrell Baseline Forecast. The SRR Valuations concluded that iGov was worth \$3.90-\$4.15 per share as of October 31, 2006 and \$5.24-\$5.39 per share as of January 30, 2007. The SLC concluded that the \$4.92 per share price was "within the range of fair market value" based on the SRR Valuations as well as Salvatori and Vinter's own professional experience in government contracting.³² Notably, despite the SRR Valuations, the SLC reasoned that \$4.92 per share "was likely too high, from a practical, real world perspective, to express the Company's value."³³

The second task SRR was charged with was to review the Chessiecap Final Valuation and the McLean Valuations and opine on them. SRR did this and helped the SLC prepare a summary comparison between the Chessiecap Valuation and McLean Valuations that was included in the SLC Report. The SLC concluded that both sets of valuations were "tainted" and reasoned that it was not necessary to determine which set of valuations was better.³⁴ The SLC concluded that it could make a recommendation respecting this suit and iGov's best interests without declaring a winner in the battle between plaintiffs' and defendants' experts.

On August 5, 2009, the SLC Report was filed. The SLC Report concludes that the suit is not in the best interests of the Company and recommends that it be dismissed. The SLC believes that the discovery that will resume if the suit is allowed to continue will be extremely disruptive to iGov's operations. The SLC also believes that negative publicity associated with the suit will immediately damage the Company's goodwill and reputation in the government contracting community.

***11** As to the actual claims asserted in plaintiffs' complaint, the SLC Report concludes as follows. First, as to Count I, the SLC concluded that defendants acted properly in adopting the 2007 Plan and did not breach their duties of care or loyalty. With regards to the duty of care, the SLC found that the 8 Del. C. § 102(b)(7) provision in iGov's certificate of incorporation exculpates directors from personal liability not involving intentional misconduct or knowing violations of the law. The SLC concluded that a duty of care claim should not be pursued because defendants breach of care conduct, if it occurred, would be covered by the § 102(b)(7) provision. As

to the duty of loyalty, the SLC concluded that defendants' approval of the 2007 Plan and actions leading to that approval would satisfy the entire fairness standard because the process employed was fair and the \$4.92 strike price was fair. As to Count II the SLC determined that no rescission of the options granted and shares sold to defendants under the 2007 Plan should occur because \$4.92 was in the range of fair market value. Finally, the SLC determined that Count III should be dismissed based on its belief that any dilution plaintiffs suffered was experienced equally by other shareholders and thus, no individual claim exists. Count III, according to the SLC, is a derivative claim arising out of the conduct alleged in Count I and should be dismissed for the same reasons that Count I should be dismissed.

After reviewing the SLC Report plaintiffs filed an opposition brief arguing that the SLC has not met the standard required by *Zapata Corporation v. Maldonado*³⁵ and its progeny for dismissal of a claim based on an SLC's recommendation in a demand-excused case. I now consider whether the SLC has met the *Zapata* standard and, consequently, whether the suit should be dismissed or permitted to proceed.

II. STANDARD

The Supreme Court's decision in *Zapata* governs demand-excused derivative cases in which the board sets up an SLC that investigates whether a derivative suit should proceed and recommends dismissal after its investigation.³⁶ In *Zapata*, the Supreme Court rejected the notion that the SLC's recommendation, made in the form of a motion to dismiss, should be subject to business judgment review.³⁷ Rather, the Supreme Court established a two-step analysis that must be applied to the SLC's motion to dismiss. The first step of the analysis is mandatory. The Court reviews the independence of SLC members and considers whether the SLC conducted a good faith investigation of reasonable scope that yielded reasonable bases supporting its conclusions.³⁸ The second step of the analysis is discretionary.³⁹ The Court applies its own business judgment to the facts to determine whether the corporation's best interests would be served by dismissing the suit. The second step is designed for situations in which the technical requirements of step one are met but the result does not appear to satisfy the spirit of the requirements.⁴⁰

***12** An SLC's motion to dismiss is a bit of a curiosity, procedurally speaking. It does not arise directly out of one of our rules of civil procedure. Rather, it is derived by

analogy to a motion to dismiss a derivative suit based upon a voluntary settlement between parties and by analogy to a Rule 41(a)(2) motion whereby a plaintiff unilaterally seeks voluntary dismissal of a complaint after the defendant files an answer.⁴¹ The Court treats the SLC's motion in a manner akin to a Rule 56 motion for summary judgment; the SLC bears the burden of demonstrating that there are no genuine issues of material fact as to its independence, the reasonableness and good faith of its investigation, and that there are reasonable bases for its conclusions.⁴² If the Court determines that a material fact is in dispute on any of these issues it must deny the SLC's motion.⁴³ When an SLC's motion to dismiss is denied, control of the litigation is returned to the plaintiff shareholder.⁴⁴ With the relevant standard broadly articulated, I now proceed to step one of *Zapata*.

III. ANALYSIS

A. Were the SLC Members Independent?

Whether an SLC member is independent “is a fact-specific determination made in the context of a particular case.”⁴⁵ When an SLC member has no personal interest in the disputed transactions, the Court scrutinizes the members' relationship with the interested directors, as that would be the source of any independence impairment that might exist.⁴⁶ The Court considers the relationship between each SLC member and the interested directors.

An SLC member does not have to be unacquainted or uninvolved with fellow directors to be regarded as independent.⁴⁷ But an SLC member is not independent if he or she is incapable, for any substantial reason, of making a decision with only the best interests of the corporation in mind.⁴⁸ Essentially, this means that the independence inquiry goes beyond determining whether SLC members are under the “domination and control” of an interested director.⁴⁹ Independence can be impaired by lesser affiliations, so long as those affiliations are substantial enough to present a material question of fact as to whether the SLC member can make a totally unbiased decision. For example, independence could be impaired if the SLC member senses that he owes something to the interested director based on prior events.⁵⁰ This sense of obligation need not be of a financial nature.⁵¹

The independence inquiry under the *Zapata* standard has often been informed by case law addressing independence in the pre-suit demand context and vice-versa.⁵² This is a useful exercise but not one without limits. As the Supreme Court noted in *Beam v. Stewart*:

Unlike the demand-excusals context, where the board is presumed to be independent, the SLC has the burden of establishing its own independence by a yardstick that must be “like Caesar's wife”-“above reproach.” Moreover, unlike the presuit demand context, the SLC analysis contemplates not only a shift in the burden of persuasion but also the availability of discovery into various issues, including independence.⁵³

*13 Unlike a board in the pre-suit demand context, SLC members are not given the benefit of the doubt as to their impartiality and objectivity. They, rather than plaintiffs, bear the burden of proving that there is no material question of fact about their independence. The composition of an SLC must be such that it fully convinces the Court that the SLC can act with integrity and objectivity, because the situation is typically one in which the board as a whole is incapable of impartially considering the merits of the suit.⁵⁴ Thus, it is conceivable that a court might find a director to be independent in the pre-suit demand context but not independent in the *Zapata* context based on the same set of factual allegations made by the two parties. This is not because the substantive contours of the independence doctrine are different in these two contexts. Rather, it is primarily a function of the shift in the burden of proof from the plaintiff to the corporation when the suit moves from the pre-suit demand zone to the *Zapata* zone.

It is undisputed that neither SLC member had a personal stake in the challenged transactions. Neither Salvatori nor Vinter received shares of stock or options under the 2007 Plan and neither faces any risk of personal liability in this suit. Moreover, Salvatori and Vinter were not appointed to the board until after the 2007 Plan was adopted. In addition, plaintiffs do not allege that any of the defendants dominate or control Salvatori or Vinter. Thus, the focus must be on whether the relationships Salvatori and Vinter have with defendants are of such a nature that they might have caused Salvatori and Vinter to consider factors other than the best interests of the corporation in making their decision to move for dismissal. Such a relationship would raise a material question as to the SLC's independence. After carefully reviewing the evidence produced by the limited

discovery thus far permitted, I conclude that there is a material question of fact as to the independence of both SLC members based on their relationships to Tyrrell.

I begin by discussing Vinter. Plaintiffs argue that Vinter's independence is impaired by one simple fact; Vinter's wife is Tyrrell's cousin. According to plaintiffs, it was that association that caused Tyrrell to approach Vinter about joining the iGov board.⁵⁵ Defendants counter that this familial relationship does not impair Vinter's independence because Tyrrell and Vinter's wife are not close cousins; they only occasionally cross paths at large family functions once or twice each year. Plaintiffs respond that, even though Tyrrell and Vinter's wife may not be particularly close, it would have been impossible for Vinter not to think of Tyrrell as "my wife's cousin" when grappling with the difficult decision of recommending whether civil litigation against him should proceed. According to plaintiffs, this is a sufficient connection to create an unacceptable risk of bias in Vinter's mind.⁵⁶

***14** Defendants cite *Beam v. Stewart*, a case in which the Supreme Court stated that "allegations of mere personal friendship or a mere outside business relationship, standing alone, are insufficient to raise a reasonable doubt about a director's independence."⁵⁷ Defendants argue that, under *Beam*, the familial connection between Tyrrell and Vinter is simply not enough to raise a material question of fact as to Vinter's independence. I disagree. *Beam* was a pre-suit demand case, and the burden in that case was on the plaintiffs to allege facts sufficient to create a reasonable doubt that the board could not objectively consider a suit against its Chairman, Martha Stewart. In their complaint, the plaintiffs broadly alleged that Stewart had personal friendships or outside business dealings with certain of the directors. This was not enough, standing alone, to create a reasonable doubt about the ability of the directors to objectively consider the merits of a suit against Stewart. In this case, however, the burden is on iGov to show that it has appointed SLC members whose independence cannot seriously be doubted. The Company, not plaintiffs, must do the explaining in the first instance if there are associations that cast a shadow on independence. Frankly, appointing an interested director's family member to an SLC will always position a corporation on the low ground. From there, the corporation must fight an uphill battle to demonstrate that, notwithstanding kinship, there is no material question as to the SLC member's objectivity. Put simply, explaining away a familial association in *Zapata* territory is a more

difficult challenge for a corporation than confronting a broad allegation of personal or business relationships in pre-suit demand territory.

I admit that it is not possible, at this stage of the proceedings, to say unequivocally that Vinter's independence is impaired. On the one hand, the relationship between Vinter's wife and Tyrrell does not seem to be particularly close. They do not frequently associate with one another as some cousins are wont to do. On the other hand, they do see each other regularly, albeit infrequently, at family functions. For example, each year Vinter and his wife attend a large family party at Tyrrell's in honor of Tyrrell's mother, who has passed away.⁵⁸ Vinter also testified in his deposition that, while he did not see Tyrrell on a regular basis or personally discuss Tyrrell's work with him before joining the iGov board, he "sort of knew where he was at any given time...."⁵⁹ Thus, the familial relationship appears to be close enough that Vinter has been kept apprised of Tyrrell's comings and goings through the family grapevine. To my mind, there is a material question of fact as to how much Vinter's family association with Tyrrell may have influenced his objectivity. I cannot say with certainty that Vinter would not have considered the potentially awkward situation of showing up to Tyrrell's annual party after the family rumor mill had spread the word that Vinter had recommended that a lawsuit should proceed against the host.⁶⁰ Therefore, I am not convinced, as I must be under *Zapata*, that Vinter's recommendation would have been solely influenced by considerations of iGov's best interests.

***15** Now to Salvatori. Like Vinter, Salvatori's contact with iGov was based on an association with Tyrrell. In 1993, Tyrrell was hired by Salvatori to work as an internal auditor for a company called QuesTech. Salvatori was a QuesTech cofounder and served as its President, CEO, and Chairman while Tyrrell was employed there for six years. During that time, Salvatori promoted Tyrrell to CFO, in which role he reported directly to Salvatori. Tyrrell worked as QuesTech's CFO until it was sold in 1998. Tyrrell appears to have made a significant and valued contribution to the efforts to sell QuesTech. In his deposition, Salvatori testified that he has "a great respect for [Tyrrell]. And he was very helpful in helping me get a good price for my company. Very helpful."⁶¹ Tyrrell's employment with QuesTech ended when it was sold. After the sale, Tyrrell and Salvatori maintained minimal connections. Their professional association was reinstated when Tyrrell approached Salvatori about joining the iGov board.

As noted, the independence of an SLC member may be impaired if that member feels he owes something to an interested director.⁶² That sense of obligation does not have to be financial in nature.⁶³ In this case, I believe there is a material question of fact as to Salvatori's independence because his earlier associations with Tyrrell may have given rise to a sense of obligation or loyalty to him. Salvatori appears to have been satisfied with the price he received for QuesTech, and he continues to feel that Tyrrell was an important factor in securing that price. In saying this, I do not find that Salvatori in fact does feel a sense of obligation to Tyrrell, but there is certainly a strong possibility that he does, and that is enough under *Zapata* to preclude dismissal.

Before moving on I note a few pieces of evidence that buttress my conclusion that there is a material question of fact regarding the SLC's independence. First, the SLC members appear to have reviewed the merits of plaintiffs' claims before the SLC was ever formed. In September 2007, plaintiffs' counsel sent a letter to iGov outlining many of the allegations that ultimately appeared in plaintiffs' complaint and requesting a meeting to begin resolving the dispute. The McLean Valuations were attached to the letter. In response, iGov's counsel sent a letter explaining that iGov disagreed with plaintiffs' allegations and would not meet until defendants and "iGov's new board members, John Vinter and Vincent Salvatori, had time to review the McLean Valuations."⁶⁴ Vinter and Salvatori both testified that they could not remember reviewing the McLean Valuations, but it is clear that the iGov audit committee, on which both men sit, reviewed the McLean Valuations on October 29, 2007.⁶⁵ When SLC members are simply exposed to or become familiar with a derivative suit before the SLC is formed this may not be enough to create a material question of fact as to the SLC's independence. But if evidence suggests that the SLC members prejudged the merits of the suit based on that prior exposure or familiarity, and then conducted the investigation with the object of putting together a report that demonstrates the suit has no merit, this will create a material question of fact as to the SLC's independence. In this case, that is what has occurred.

***16** Two similar pieces of evidence suggest that Vinter and Salvatori may not have conducted their investigation objectively after having considered plaintiffs' claims. First, Salvatori was asked in his deposition about the SLC's efforts to investigate the allegations in plaintiffs' complaint. Salvatori responded "I know we read it all over and I know we

attacked it all."⁶⁶ Plaintiffs' counsel followed up with "[y]ou did what it all?" to which Salvatori answered "[a]ttacked it all."⁶⁷ Salvatori's counsel then repeated "[a]ttacked it all" after which Salvatori changed his answer to "[w]e considered it."⁶⁸ To my mind, the word "attack" in this context suggests something other than objectivity. But I readily admit that expressions can be misinterpreted and words can be inadvertently misused. In fact, if this were the only piece of evidence suggesting that the SLC might have engaged in a combative assault rather than an investigation I would be inclined to consider Salvatori's use of the verb "attack" as ambiguous. But the second piece of evidence has Vinter using the same verb—"attack"—in relation to the McLean Valuations.

Vinter's notes from a June 26, 2009 meeting, at which SRR gave an update of its views of the \$4.92 strike price, state as follows:

McLean *attack*

-forecast

-low margin 1.3 # 1.5

-marketability discount

-fully diluted approach⁶⁹

As one can see, this appears to be a bullet-point summary of what is purportedly wrong with the McLean Valuations. Some of these criticisms of the McLean Valuations ended up in the SLC Report. In his deposition, Vinter stated his belief that he thought the word "attack" in the notes really said "attach."⁷⁰ But "attach" does not make any sense in the context of the note.

Plaintiffs characterize Salvatori and Vinter's uses of the word "attack" as an indication that from the outset of the investigation the SLC was gathering information with the object of putting together a report that cast doubt on the merits of plaintiffs' claims, rather than objectively considering plaintiffs' claims. Given the SLC members' relationships to Tyrrell, their exposure to the merits of plaintiffs' suit well before the SLC was formed,⁷¹ and the unsatisfactory scope of the investigation conducted (of which more will be said below), Salvatori and Vinter's use of the word "attack" does not help to fully convince me that the SLC was independent.

In sum, the independence inquiry under *Zapata* is critically important if the SLC process is to remain a legitimate mechanism in our corporate law.⁷² SLC members should be selected with the utmost care to ensure that they can, in both fact and appearance, carry out the extraordinary responsibility placed on them to determine the merits of the suit and the best interests of the corporation, acting as proxy for a disabled board. In this case, I am not satisfied that the independence prong of the *Zapata* standard has been met.

B. Did the SLC Conduct an Investigation of Reasonable Scope in Good Faith and Did the SLC Have Reasonable Bases for its Conclusions?

*17 Because the manner in which the SLC investigated plaintiffs' complaint bears directly on whether it had reasonable bases for its conclusions, I will address both of these aspects of the *Zapata* test together. I begin with an overview of the legal standards for these two components of the test.

To conduct a good faith investigation of reasonable scope, the SLC must investigate all theories of recovery asserted in the plaintiffs' complaint.⁷³ In doing this, the SLC should explore all relevant facts and sources of information that bear on the central allegations in the complaint.⁷⁴ If the SLC fails to investigate facts or sources of information that cut at the heart of plaintiffs' complaint this will usually give rise to a material question about the reasonableness and good faith of the SLC's investigation.⁷⁵ In addition, before an SLC decides not to explore specific acts of alleged misconduct because the costs of a full investigation outweigh any harm that may have been caused by those specific acts, the SLC should carefully analyze whether a summary investigation of those specific acts could shed light on the more serious allegations in the plaintiffs' complaint.⁷⁶ A total failure to explore the less serious allegations in plaintiffs' complaint may cast doubt on the reasonableness and good faith of an SLC's investigation when exploring those less serious allegations, at least in summary fashion, would have helped the SLC gain a full understanding of the more serious allegations in plaintiffs' complaint.⁷⁷ Finally, an SLC fails to conduct a reasonable investigation if it simply accepts defendants' version of disputed facts without consulting independent sources to verify defendants' assertions.⁷⁸

To demonstrate that its recommendations are supported by reasonable bases, the SLC must show that it correctly

understood the law relevant to the case. If the SLC's recommendation is based on an error of law then the basis for that recommendation is not reasonable.⁷⁹ Moreover, if the SLC gets the undisputed facts wrong in its report, and then relies on its erroneous recitation of the undisputed facts in making its dismissal recommendation, it also goes without saying that the basis for the recommendation is not reasonable.⁸⁰

Having articulated the relevant standards I turn to the SLC Report to determine if it demonstrates a reasonable investigation conducted in good faith and reasonable bases for the SLC's recommendation that this case be dismissed. The SLC Report identifies the SLC's recommendations for each of the three counts in plaintiffs' complaint. As we have seen, Count I alleges that defendants breached their fiduciary duties of care and loyalty by adopting the 2007 Plan. The duty of care claims are based on the allegation that defendants approved the 2007 Plan knowing that Chessiecap's Final Valuation was based on stale and incomplete information in the Revised Chessiecap Forecast. The duty of loyalty claims are based on the allegation that defendants intentionally provided misleading and incomplete information to Chessiecap in order to artificially depress iGov's value so that defendants would receive underpriced options and shares when the 2007 Plan was implemented. Count II seeks rescission of the 2007 Plan and is essentially dependent on the success of Count I. Count III is styled as an individual claim, the personal harm being that defendants improperly diluted plaintiffs' ownership interests, thereby expropriating economic value and voting power from them. I analyze the SLC's recommendation on each count in turn.

1. The Duty of Care Claims in Count I

*18 The SLC first addressed Count I, ultimately concluding that it should be dismissed. As to the duty of care claims in Count I, the SLC found that the 8 *Del. C.* § 102(b)(7) provision in iGov's corporate charter exculpates directors from personal liability for monetary damages so long as the director did not engage in intentional misconduct or knowing violations of the law.⁸¹ The SLC concluded that a duty of care claim should not be pursued because defendants breach of care conduct, if it occurred, would be covered by the § 102(b)(7) provision.

I take this opportunity to note the first of many concerns I have with the conclusions in the SLC Report. In finding that the action should not be pursued on the basis of duty of care claims, the SLC noted that § 102(b)(7) provisions such

as iGov's are routinely upheld by Delaware courts and that such a provision protects defendants from personal liability, in the form of money damages, for gross negligence. *On that basis alone*, the SLC concluded that duty of care claims against defendants should not be pursued. I find this to be an unreasonable conclusion because the SLC failed to consider that the requested relief in plaintiffs' complaint is not limited to money damages; it specifically requests that the 2007 Plan be rescinded. Under Delaware law, exculpatory provisions do not bar duty of care claims "in remedial contexts ..., such as in injunction or rescission cases."⁸² Thus, if I became convinced at the summary judgment stage or after a trial on the merits that defendants breached their duty of care the exculpatory provision in the iGov charter would not preclude me from ordering rescission of the 2007 Plan, even though it might preclude me from entering a judgment for monetary damages against defendants.⁸³ It was unreasonable, therefore, for the SLC to conclude that the duty of care claims in Count I should not go forward solely on the basis of iGov's § 102(b)(7) provision. The SLC simply fails to understand that Delaware law permits a suit seeking rescission to go forward despite a § 102(b)(7) provision protecting directors against monetary judgments.

2. The Duty of Loyalty Claims in Count I

The SLC's investigation of plaintiffs' duty of loyalty claims, as well as its conclusion that those claims should be dismissed, merits the most discussion in my analysis of the *Zapata* requirements. The SLC concluded that plaintiffs' duty of loyalty claims should be dismissed because it believes the 2007 Plan was entirely fair to iGov. Underlying this conclusion are the SLC's findings that (1) the process defendants' employed to secure approval of the 2007 Plan, particularly the process employed to develop the exercise price, was entirely fair, and (2) \$4.92 was a fair exercise price.

a. Fair Process

I begin by analyzing whether the SLC's investigation of defendants' process was reasonable in scope. I also analyze whether the SLC's conclusion that the process was fair is supported by reasonable bases. In conducting this analysis I avoid considering the merits of plaintiffs' claims.⁸⁴ My findings here relate only to the SLC's investigation.

***19** In concluding that defendants would be able to show fair dealing, the SLC first determined that plaintiffs' claims can be:

distilled ... to *one key issue*. Can a CFO have one forecasting model for the purpose of seeking an increase in the Company's credit availability and for [internal] goal-setting while, at the same time, have a *substantially lower* forecast for the purpose of valuing the Company's equity?⁸⁵

A natural place for me to begin my inquiry is with the SLC's own characterization of the key issue underlying plaintiffs' complaint. Namely, was it acceptable for Tyrrell to provide Chessiecap with the Revised Chessiecap Forecast showing an EBITDA of \$1.8 million while simultaneously providing Textron with multiple iterations of EBITDA forecasts, all of which showed an EBITDA of at least \$3 million, and using internal EBITDA forecasts that also projected an EBITDA of at least \$3 million? The SLC concluded that this was an acceptable thing for Tyrrell to do. The SLC Report explains this conclusion as follows:

The existence of multiple forecasts circulated internally and externally during the same time frame, in and of itself, is not indicative of anything nefarious or ill-motivated. It is not unusual for CFOs to analyze and estimate a company's future performance and test their predictions and assumptions. It is also not unusual for CFOs to provide an *optimistic* outlook to its lender when the goal is to instill confidence in the company's ability to comply with its covenant requirements and seek an increase in the availability of the credit line. A forecast that is optimistic is not misleading, it merely reflects the guessing of what the Company *may* accomplish if certain favorable events occur as the management hopes they will. We see no value for a CFO to present a pessimistic case when seeking financing. By the same token, an optimistic forecast is often used by management as a goal setting tool to inspire and incentivize the company's employees who may have incentive based compensation rooted in hitting certain set benchmarks. Setting a high goal is a necessary tool to motivate performance. Such practice is widespread and not misleading, ill-motivated or self-dealing. On the other hand, a CFO can also

have a forecast that he believes the company will actually achieve, rather than a wishful “may” achieve. It is that forecast that the Committee believes should be utilized for estimating the value of the Company's equity.⁸⁶

Elsewhere in the SLC Report this conclusion is reemphasized:

With regard to the forecasts identified by Plaintiff but not provided to Chessiecap, [] Tyrrell stated to the SLC that it was his usual practice regularly to create such varying forecasts for purpose of motivating employees and testing “what if” scenarios. He also created optimistic forecasts showing “*the art of the possible*” to instill confidence in the Company's lender by showing what the Company hoped to achieve, and to illustrate to management how best to position the Company for future growth. The Committee finds that it is not uncommon for CEOs of companies to run varies (sic) scenarios and forecasts particularly for a company like iGov that remained in transition mode through 2006 and 2007. Moreover, the record compiled by the SLC for the period 2006-2007 and the SLC's experience serving on the Board of iGov, corroborate [] Tyrrell's statements and confirm his business practices.⁸⁷

***20** As is evident from the SLC Report, the SLC concluded that the process of adopting the 2007 Plan was fair primarily because the SLC believes it was perfectly normal for Tyrrell to provide “optimistic” and “art of the possible” forecasts to Textron and use those forecasts internally, while at the same time providing a forecast to its valuation expert that was “substantially lower” but something the Company could “actually achieve,” rather than being “wishful.” To put it mildly, this is an interesting conclusion, especially in light of the current credit environment. One would suspect that lenders would prefer a forecast projecting what management believes is actually achievable as opposed to wishful. In and of itself, this conclusion does not inspire confidence that the SLC conducted a good faith investigation. But I need not rest my decision solely on the merits of this crucial conclusion, because, broadly speaking, I do not believe that the SLC's investigation was sufficient in scope to adequately address plaintiffs' duty of loyalty claims. Nor do I believe the SLC

developed reasonable bases for concluding plaintiffs' duty of loyalty claims should be dismissed.

An obvious first question that was not adequately explored by the SLC is this: why did Tyrrell provide Chessiecap with the Original Chessiecap Forecast (showing an EBITDA of roughly \$3 million) if he did not believe that the projections in that forecast were actually achievable? Why put Chessiecap to the time, expense, and effort of developing a valuation based on an overly optimistic projection? The SLC addresses this question, but provides an answer that contradicts the key conclusion of its investigation. Specifically, the SLC Report states that the Original Chessiecap Forecast was the “only operating forecast available” to give to Chessiecap in August 2006.⁸⁸ Of course, that is inconsistent with the SLC's finding that it was Tyrrell's “usual practice regularly to create [] varying forecasts....”⁸⁹ By August 2006, Tyrrell had worked at iGov for nearly a year, plenty of time to have developed more than one forecast if he actually did that on a regular basis. Moreover, iGov was nearing the end of its fiscal year at that time and so, if it was Tyrrell's usual practice to create varying forecasts, one would assume he would have developed more than one forecast for the next year by then. The SLC does not explain this inconsistency, and it is the only basis on which it attempts to explain away Tyrrell first providing Chessiecap with the Original Chessiecap Forecast, a projection that was identical to the Second Textron Forecast that iGov had sent to its lender the same month. The SLC's finding that the Original Chessiecap Forecast was the only one available actually provides evidentiary support for plaintiffs' assertion that Tyrrell began manipulating forecasts to depress iGov's valuation. This cannot be a reasonable basis upon which to conclude that plaintiffs' complaint should be dismissed.

***21** A second question that was not adequately investigated by the SLC is why did Tyrrell provide Textron with the Third Textron Forecast (showing an EBITDA of 3.1 million) *after* he provided Chessiecap with the Revised Chessiecap Forecast (showing an EBITDA of \$1.8 million)? The SLC Report explains that the SLC interviewed Tyrrell multiple times and that in those interviews Tyrrell testified that he provided Chessiecap with the Revised Chessiecap Forecast on October 18, 2006 because he believed it was a more realistic projection for FY07. The SLC accepted Tyrrell's testimony on this point as true without adequately exploring contrary evidence. For example, why would Tyrrell have been comfortable continuing to provide Textron with forecasts that were higher than what he believed was realistic?⁹⁰ The SLC

found that Tyrrell provided Textron with the Third Textron Forecast because he wanted to ensure that financing would be obtained.⁹¹ But the SLC never tested whether Tyrrell genuinely believed he was sending Textron overly optimistic forecasts by asking him why he was comfortable providing a potential creditor with data he did not believe was realistic. It was not reasonable for the SLC to accept Tyrrell's assertion that the Revised Chessiecap Forecast was the most realistic without exploring Tyrrell's conduct that suggests otherwise.

The SLC also did not adequately address the ample evidence that internal forecasts continued to project EBITDA of roughly \$3-4 million, a figure much higher than the Revised Chessiecap Forecast.⁹² As we have seen, Tyrrell's own emails suggest that he believed these higher internal forecasts were achievable, in direct contradiction to the testimony he provided the SLC, but the SLC does not appear to have questioned him thoroughly about these emails. Instead, the SLC explains away these internal forecasts with its finding that they were used to motivate and inspire management by demonstrating what *might* be achievable, rather than what Tyrrell actually believed was achievable. The SLC's finding on this point appears to be completely based on Tyrrell's assertions about the purpose of the internal forecasts. Nothing in the SLC Report suggests that management was questioned to see if they understood that the internal projections being circulated were not what the CFO believed was actually achievable. In fact, there was evidence that iGov management generally believed that an EBITDA of \$3 million or more was realistic for FY07.⁹³

Based on the SLC's own investigation, it appears that the only character in this story to rely on the relatively lower, but "actually achievable" numbers reflected in the Revised Chessiecap Forecast was Chessiecap—the firm that, according to plaintiffs' complaint, was manipulated to provide a low valuation that directly benefitted defendants. Per the SLC's own findings, then, all other characters were relying on projections that were "art of the possible" but probably not achievable. From the point of view of an objective SLC conducting a good faith investigation, this discovery is clearly problematic. Absent some further explanation, it inferentially supports plaintiffs' allegations that manipulation had occurred. An objective SLC would have been *duty bound* at this point to thoroughly explore why management pervasively used forecasts it did not believe were realistic, but the SLC failed to do this. Rather, it appears to have accepted Tyrrell's representations that the Revised Chessiecap Forecast was the most accurate without pressing him on why he felt the

only appropriate use of the most accurate forecast was valuing iGov's equity in connection with the 2007 Plan.

*22 A third question the SLC Report did not adequately address was the assertion in plaintiffs' complaint that Tyrrell only considered negative developments that had occurred after the July 31, 2006 valuation date when preparing the Revised Chessiecap Forecast. Plaintiffs' complaint provides examples of positive developments that had occurred but were purportedly ignored by Tyrrell; specifically, the \$7 million PTO contract that was awarded in September 2006 and the increased profitability in the TACLAN contract that was becoming apparent. Moreover, plaintiffs' complaint alleges that when the 2007 Plan was finally approved on January 31, 2007, defendants were even more aware of the TACLAN contract's better-than-expected performance, as well as the increasing likelihood that the DHS contract would be awarded, but made no efforts to have Chessiecap update its Final Valuation to reflect this.

Nothing in the SLC Report indicates that the SLC seriously investigated plaintiffs' allegations that the Revised Chessiecap Forecast ignored positive developments while incorporating negative developments. Nor does the SLC Report provide me with any comfort that the SLC adequately investigated whether defendants adopted the 2007 Plan despite knowing that the Final Valuation upon which it was based failed to reflect the positive developments that had occurred since July 31, 2006. Tyrrell had specifically stated his belief on January 7, 2007 that the Final Valuation was old and would likely be higher when it was updated and then just a few days later represented to Chessiecap that no material changes had occurred since July 31, 2006. Likewise, Neven and Hupalo implicitly represented that no material changes had occurred by adopting the 2007 Plan based on the Final Valuation. There is no evidence that the SLC questioned any of defendants as to why they felt the PTO contract, the increased TACLAN profitability, or the increasing likelihood of a DHS contract award were not material developments. Perhaps there would have been defensible reasons for defendants to come to these conclusions, but we are left wondering because the SLC did not investigate it. This was a failure to investigate a fundamental theory of recovery in plaintiffs' complaint that precludes me from granting the SLC's motion to dismiss.⁹⁴

While I am on the subject of the absence of "material changes" I should discuss a fourth question that the SLC did not investigate; namely, the award of 25,000 options to Marksberry in May 2007. These options were awarded at

\$4.92 per share, the same price as the options under the 2007 Plan. The SLC reasoned that it would not have been useful to explore this grant because Marksberry was no longer employed by iGov at the time of the investigation and could not exercise any of the 25,000 shares he had been granted. The SLC believed that iGov was in no danger of being harmed by this grant and therefore it would not be cost-beneficial to investigate it.

***23** The SLC is undoubtedly correct that the 25,000 option grant to Marksberry does not threaten iGov economically. But that does not mean investigating the option grant would not have shed light on the merits of plaintiffs' complaint. The grant occurred ten months after the Final Valuation upon which the \$4.92 per share price was based. Plaintiffs allege that by that time it was abundantly clear that positive, material developments had occurred that made the Final Valuation upon which the \$4.92 strike price was based unreliable. Among other things, plaintiffs point out that the DHS contract had been formally awarded in March 2007. Tyrrell's rationale for excluding the DHS contract from the Revised Chessiecap Forecast was that it had not been formally awarded. Thus, it at least seems reasonable that once the DHS contract was formally awarded the Revised Chessiecap Forecast should have been revised again to account for profits from the DHS contract. Nevertheless, defendants did not provide Chessiecap with any revised forecast or ask them to update their Final Valuation. Rather, defendants adopted a formal resolution that specifically stated no material changes had occurred since July 31, 2006 and awarded Marksberry options on that basis.

The SLC declined altogether to investigate this transaction. They did not question defendants about their resolution that no material change had occurred as of May 2007, despite the DHS contract having been formally awarded. If the SLC had investigated this transaction, it likely would have shed light on the broader allegations in plaintiffs' complaint.⁹⁵ Specifically, the SLC could have gained insight into defendants' motivations with respect to the 2007 Plan. By simply asking defendants why they believed no "material change" had occurred for equity valuation purposes since the Final Valuation, the SLC could have determined what sort of change defendants needed to see before they would feel it necessary to update the Final Valuation and could have evaluated whether defendants' assessments were being made in good faith or whether they were ill-motivated. Defendants were willing to award Marksberry options at the \$4.92 strike price despite the formal award of the DHS contract. This behavior calls into question the sincerity of Tyrrell's earlier

assertion that the DHS contract should not be included in a forecast until it was formally awarded. The SLC should have challenged defendants on this point. It may have taken nothing more than a few questions. But the SLC declined to do so. Seeing this omission, I must conclude that the SLC's investigation into plaintiffs' duty of loyalty claims was not reasonable in scope.

A fifth problem is that the SLC Report fails to investigate the timing of plaintiffs' removal from the board. As we've seen, plaintiffs were removed from the board just days after they protested the use of the Final Valuation, alleging that it was based on stale and inaccurate information in the Revised Chessiecap Forecast. Plaintiffs' complaint contends that defendants' plan was to procure iGov shares for themselves at artificially low prices and to entrench themselves in management and directorship positions through the increased ownership percentages they would realize under the 2007 Plan. To that end, plaintiffs allege that they did not receive any shares under the 2007 Plan, which was adopted just days after their removal from the board, and that their ownership percentages were decreased by the 2007 Plan while defendants' ownership increased.

***24** The SLC Report characterizes plaintiffs' removal from the board as the product of a disagreement between plaintiffs and defendants over the direction that iGov should take. The SLC Report characterizes plaintiffs, specifically Hunt, as wanting iGov to drop all other pursuits so that it could "milk" the TACLAN contract. In contrast, the SLC Report describes defendants, specifically Neven and Hupalo, as wanting to grow iGov and use the TACLAN contract as a stepping stone to reinvent the Company from a low-margin information technology reseller into a higher-margin service provider. The SLC Report states:

During their interviews, Neven and Hupalo displayed a sense of personal responsibility for the employment of almost one hundred people and felt that the Company had become the home to hardworking individuals who were committed to serving the government and building a great product. It was that sense of long-term commitment to iGov by Neven and Hupalo, in contrast to Hunt's short-term objectives, that divided ... and ultimately shattered the Board.⁹⁶

Conspicuously absent from the SLC Report are any citations to interview notes or other evidence supporting the SLC's finding that this disagreement was the cause of plaintiffs' removal from the board. In fact, there is evidence in the record that shows defendants may have been just as interested in maximizing short-term profits from iGov as plaintiffs' purportedly were, but the SLC Report fails to investigate or explain this.⁹⁷ The biggest problem, though, is that the SLC Report wholly fails to analyze or explain why plaintiffs were removed from the board only three days after objecting to the Final Valuation and a little less than two weeks before the 2007 Plan was adopted. There is no indication that the SLC probed defendants on why they felt it was necessary or advisable to remove plaintiffs from the board almost immediately after they objected to the Final Valuation and then shortly thereafter approve the 2007 Plan, which plaintiffs were certain to vote against. In fact, the SLC Report gets the date of plaintiffs' removal from the board wrong. It states: "*By the end of December 2006*, the relationship among the Founders had deteriorated and Neven and Hupalo, acting as majority shareholders removed London and Hunt from the Board of Directors."⁹⁸ Thus, the SLC Report gets a fundamental, undisputed fact from plaintiffs' complaint wrong and then fails to conduct the investigation that would have been necessary if the SLC had the facts right. This does not demonstrate that the SLC conducted an investigation of reasonable scope.⁹⁹

A sixth area of inadequate investigation deserves mention. The SLC Report assumes that defendants Neven and Hupalo gave up options with a \$1.25 strike price from the 2000 Plan for options with a strike price of \$4.92 in adopting the 2007 Plan. Presumably this finding is included in the SLC Report to demonstrate the good faith of defendants in adopting the 2007 Plan. The SLC concludes that all parties agreed that the 2007 Plan was adopted to replace the 2000 Plan to correct the defects in the 2000 Plan. The SLC fails to acknowledge, however, evidence suggesting that defendants' knew the options under the 2000 Plan were never granted to them. Specifically, in September 2006, Tyrrell told Neven that the options under the 2000 plan were never issued.¹⁰⁰ In addition, on October 26, 2006, iGov's corporate counsel gave the opinion that the options were never granted.¹⁰¹

***25** Since the SLC believed that the 2007 Plan was designed to replace the problematic \$1.25 options that had been granted under the 2000 Plan, it should have investigated why London did not receive options under the 2007 Plan to replace the

options he had purportedly been granted under the 2000 Plan. According to the SLC, London, Neven, and Hupalo had all been given defective options under the 2000 Plan. Yet only Neven and Hupalo had those defective options replaced when they voted to adopt the 2007 Plan. London was not permitted to vote on the 2007 Plan (because he had been removed from the board) and was not given replacement options under the 2007 Plan. Surely this should have suggested something about the fairness of the 2007 Plan adoption process from the SLC's perspective. And yet the SLC did nothing to investigate this.

I could go on, but I decline to.¹⁰² What I have written is sufficient to demonstrate that there is a material question of fact as to whether the SLC conducted a good faith investigation of reasonable scope into the fairness of the 2007 Plan's adoption process.

b. Fair Price

Having determined that the SLC did not conduct a reasonably thorough investigation into defendants' process for adopting the 2007 Plan and did not have reasonable bases for concluding that the process was fair, I could dispense with the remainder of the entire fairness inquiry. Nevertheless, to be thorough, I will briefly explore the SLC's investigation of price and whether it had reasonable bases to conclude that \$4.92 per share was a fair price.

The SLC ultimately determined that both the Chessicap Final Valuation and McLean Valuations were "tainted" and did not rely on either valuation in concluding that \$4.92 was a fair price.¹⁰³ The SLC partially relied on the SRR Valuations in concluding that \$4.92 was a fair price. I say "partially" because the SLC Report summarily marginalizes the SRR Valuations, which concluded that iGov equity was worth \$3.90-\$4.15 as of October 31, 2006 and \$5.24-\$5.30 as of January 30, 2007. The SLC Report concludes that \$4.92 was in the range of fair market value based on the SRR Valuations, but then states that "\$4.92 ... was likely too high, from a practical, real world perspective...."¹⁰⁴ The SLC Report takes the position that the SRR Valuations \$5.24-\$5.30 per share estimate for January 30, 2007 was largely a function of iGov's cash position on that date, and was not an indication of the real value of the Company. This disagreement about the effect of iGov's cash position on value, combined with the SLC's hunches about the Company's value, led the SLC to conclude that even the SRR Valuations missed the mark. Thus, the SLC is left with no professional valuation upon which to hang its hat entirely. That is certainly enough to

create a material question of fact about whether the SLC had a reasonable basis to conclude that \$4.92 was a fair price.

Compounding this problem though is the fact that SRR utilized the Tyrrell Baseline Forecast (showing an EBITDA of \$2.1 million) in preparing its valuation. The SLC Report indicates that SRR was given the Tyrrell Baseline Forecast because:

*26 ... Tyrrell testified that he viewed the [Tyrrell Baseline Forecast] as a more realistic projection for FY2007. Tyrrell testified that this forecast was a revision of the [Revised Chessiecap Forecast] previously provided to Chessiecap and did not contain the operational or motivational assumptions found in the [Third Textron Forecast]. The SLC concluded, therefore, that as of December 2006, the [Tyrrell Baseline Forecast] was the most accurate prediction of the Company's likely performance....¹⁰⁵

There are at least two problems with the SLC's decision to provide SRR with the Tyrrell Baseline Forecast for its analysis. First, as is evident from the language cited, the SLC determined that the Tyrrell Baseline Forecast was the most appropriate forecast for SRR to use solely based on Tyrrell's testimony. This was not a reasonable basis for such a determination. Serious doubts are raised about an SLC's investigation where it does not consult sources of information other than one of the defendants to make conclusions.¹⁰⁶

The second problem is related to the first. The SLC does not appear to have actually understood the Tyrrell Baseline Forecast. Tyrrell described the Tyrrell Baseline Forecast as being a revision of the Revised Chessiecap Forecast, but this was inaccurate. The SLC appears to have accepted this characterization, and included it in the SLC Report, without actually testing it. A close comparison reveals that the Tyrrell Baseline Forecast was identical to the Third Textron Forecast with the exception that two line items differed. The principal difference between the Tyrrell Baseline Forecast and the Third Textron Forecast was the revenues and expenses from the DHS contract. As we have seen, the DHS contract was one of the major line items, if not *the* major line item, that plaintiffs accuse Tyrrell of adjusting to manipulate the valuations. If the SLC had compared the Tyrrell Baseline Forecast to the Third Textron Forecast it would have noticed that the two were substantially identical with the exception

that DHS contract revenue and expenses were omitted from the Tyrrell Baseline Forecast. This omission largely caused the Tyrrell Baseline Forecast to project an EBITDA of \$2.1 million, 32% lower than the Third Textron Forecast's EBITDA projection of \$3.1 million. This difference should have been addressed by the SLC because it provides evidentiary support for plaintiffs' assertion that Tyrrell was manipulating the DHS contract in his projections. But the SLC did not do this because it accepted Tyrrell's inaccurate description of the Tyrrell Baseline Forecast at face value. SRR's consequent reliance on the Tyrrell Baseline Forecast leaves me with a material doubt as to the bases upon which the SLC grounded its conclusion that \$4.92 was a fair price. I cannot grant the SLC's motion under the *Zapata* standard where such doubts exist.

Before moving on to Counts II and III I wish to make something clear. I have no opinion at this stage of the proceedings as to the fair market value of iGov shares on January 30, 2007. I have not attempted to determine which valuation is the most accurate. I have simply evaluated the scope of the SLC's investigation into the \$4.92 price and the bases of its conclusions regarding the \$4.92 price and have found that it leads me to conclude that the SLC's investigation did not meet the *Zapata* requirements.

3. Counts II and III

*27 I briefly address Counts II and III before concluding my *Zapata* step-one analysis. The SLC recommended that Count II be dismissed because it believed adoption of the 2007 Plan was entirely fair to iGov and, therefore, plaintiffs would not prevail on Count I. Because the SLC failed to meet the *Zapata* standard its recommendation to dismiss Count I is denied. Accordingly, Count II, which seeks rescission of the 2007 Plan, will not be dismissed for the obvious reason that rescission may be the appropriate remedy if plaintiffs ultimately prevail on the merits of Count I.

With respect to Count III, the SLC concluded it was a derivative claim and should be dismissed along with Count I (and for the same reasons). Plaintiffs assert that this is an individual claim over which the SLC has no power. Because I am permitting plaintiffs to continue piloting derivative claims through this litigation, I will not spend time at this juncture attempting to resolve whether Count III alleges individual or derivative claims. Either way the claims survive. We can leave determination of the exact nature of Count III for another day. In fact, a more accurate determination may be

made at a later time when the benefits of full discovery have enlarged the record.

C. The Court's Independent Business Judgment

Having determined that I will not grant the SLC's motion to dismiss after fully applying the first step of the *Zapata* standard to the motion, I find it unnecessary to apply the second step of *Zapata*. In my view, this is not a case where application of the second step will add anything of value, and so I exercise my discretion not to apply this step.

IV. CONCLUSION

Because there are material questions of fact as to the SLC's independence, the reasonableness of its investigation, and whether it had reasonable bases for its conclusions, the SLC's motion to dismiss plaintiffs' complaint is DENIED.

IT IS SO ORDERED.

Parallel Citations

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Footnotes

- 1 Pls.' Answer Ex. 12.
- 2 *Id.*
- 3 Associated expenses were also lowered.
- 4 Compl. ¶ 26.
- 5 The Second Textron Forecast and the Original Chessiecap Forecast are important to our story because, as will be discussed, plaintiffs' valuation expert, the McLean Group, relied on these identical forecasts in conducting a separate valuation of iGov.
- 6 SLC Report Ex. L-8.
- 7 Revenues from the Air Force unit were not completely eliminated. They were revised downward from \$6 million to \$900,000.
- 8 As will be discussed, plaintiffs also allege that when the 2007 Plan was approved on January 30, 2007, defendants were certain the TACLAN contract was performing better than anticipated but made no efforts to have Chessiecap update the Final Valuation to reflect this.
- 9 SLC Report Ex. L-16.
- 10 Some of the individual line items in the forecast were markedly more positive and others were more negative. The net difference in EBITDA between the forecasts, however, was not especially pronounced: \$3.1 million in the Third Textron Forecast versus \$3 million in the Second Textron Forecast.
- 11 Projected costs for these units were also higher.
- 12 The Tyrrell Baseline Forecast is important to our story because, as will be discussed, this forecast was relied upon by the SLC's independent valuation firm, Stout Risius Ross, in conducting its valuation of iGov.
- 13 SLC Report Ex. L-20.
- 14 Pls.' Answer Ex. 33.
- 15 Marksberry was brought over from the same consulting firm as Tyrrell, Tatum LLC.
- 16 SLC Report Ex. L-23. It is worth noting here that Tyrrell's characterization of the Third Textron Forecast (sent to Textron and Marksberry) as the "baseline case" contradicts defendants' characterization of the Tyrrell Baseline Forecast (sent to SRR) as the "baseline forecast."
- 17 SLC Report Ex. L-26.
- 18 SLC Report Ex. L-29.
- 19 SLC Report Ex. L-21.
- 20 *Id.*
- 21 SLC Report Ex. L-22.
- 22 SLC Report Ex. M.
- 23 SLC Report 63.
- 24 In calculating defendants' collective ownership interests, plaintiffs include shares owned by Pooley, who is not a defendant in this suit. According to plaintiffs, Pooley was controlled by Neven during all relevant periods and should be considered part of defendants' voting block. If Pooley's shares are not included in the calculation, the 2007 Plan increased defendants' collective ownership interests from 42.5% to 47.1%. On a fully diluted basis defendants' collective ownership interests increased from 40.9% to 49.3%.

- 25 In support of this last point about the TACLAN contract plaintiffs proffer an email from Tyrrell to Textron on October 12, 2006 reporting that iGov “now has \$39 million in delivery orders for TACLAN. This is huge because it's the first time that our backlog has been so large and predictable.” See SLC Report Ex. L-9. Plaintiffs also proffer an email from Tyrrell to iGov management on January 17, 2007 reporting on December 2006 income and explaining that “TACLAN led the way with \$6.1 million in Revenues and over \$655K in Net Income, which covered nearly 90% of our Operating Expenses for the month ... Overall, TACLAN did much better than expected....” See SLC Report Ex. L-27. In addition, the Revised Chessiecap Forecast showed TACLAN's projected gross profit for FY07 at approximately \$4.5 million while the Third Textron Forecast showed TACLAN's projected gross profit for FY07 at approximately \$6.5 million. Thus, the financials Tyrrell gave Textron on December 8, 2006 projected TACLAN's gross profit to be \$2 million higher for FY07 than the financials Tyrrell provided to Chessiecap on October 18, 2006.
- 26 This is significant in part because 8 Del. C. § 144 provides that transactions approved by interested directors are not void or voidable if the transaction (1) is also approved by a majority of disinterested directors after disclosure of all the material facts, (2) is approved in good faith by the *disinterested* shareholders after disclosure of all the material facts, or (3) is fair to the corporation at the time it is approved by the board. Defendants were interested in the 2007 Plan and comprised the entire board at the time they approved it, so the 2007 Plan cannot be sustained under the first prong of § 144. After the 2007 Plan was enacted plaintiffs collectively owned a majority of the disinterested shares, so their vote would be necessary to validate the 2007 Plan under the second prong of § 144, but that did not happen. Accordingly, the 2007 Plan can only be upheld if it was fair to iGov when it was enacted. See *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 366 n. 34 (Del.1993) (“Under this statute, approval of an interested transaction by either a fully-informed disinterested board of directors ... or the disinterested shareholders ... provides business judgment protection.”).
- 27 Defendants, acting as the entire board, had to approve this grant because the delegated authority to Neven and Tyrrell had expired.
- 28 SLC Report Ex. L-30.
- 29 The Second Textron Forecast was identical to the Original Chessiecap Forecast.
- 30 *London v. Tyrrell*, 2008 WL 2505435 (Del.Ch. June 24, 2008).
- 31 SLC Report 63 (“The [Final] [V]aluation ... relied upon iGov financial data for the fiscal year ending October 31, 2006. In the opinion of the [SLC] and SRR, Chessiecap's valuation is more properly viewed as a valuation as of October 31, 2006.”).
- 32 SLC Report 50.
- 33 *Id.*
- 34 SLC Report 47.
- 35 430 A.2d 779 (Del.1981).
- 36 *Zapata Corp. v. Maldonado*, 430 A.2d 779, 784 (Del.1981).
- 37 *Id.* at 787.
- 38 *Id.* at 789.
- 39 *Id.*; *Kaplan v. Wyatt*, 499 A.2d 1184, 1192 (Del.1985) (holding that the second step of the *Zapata* analysis is discretionary).
- 40 *Zapata*, 430 A.2d at 789.
- 41 *Kaplan v. Wyatt*, 484 A.2d 501, 506-07 (Del.Ch.1984).
- 42 *Id.* at 507.
- 43 *Id.* at 508.
- 44 *Id.* at 509.
- 45 *Beam v. Stewart*, 845 A.2d 1040, 1050 (Del.2004).
- 46 *Katell v. Morgan Stanley Group, Inc.*, 1995 WL 376952, at *8 (Del.Ch. June 15, 1995).
- 47 *Sutherland v. Sutherland*, 958 A.2d 235, 241 (Del.Ch.2008).
- 48 *In re Oracle Derivative Litig.*, 824 A.2d 917, 920 (Del.Ch.2003).
- 49 *Id.* at 937.
- 50 *Id.* at 939 n. 52.
- 51 *Id.* at 938-39.
- 52 For example, in *Oracle*, a case governed by *Zapata*, after articulating what it means for an SLC member to be independent, the Court noted that “[t]his formulation is wholly consistent with the teaching of *Aronson* [a pre-suit demand case], which defines independence as meaning that ‘a director's decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences.’” *Oracle*, 824 A.2d at 938 (citing *Aronson v. Lewis*, 473 A.2d 805, 816 (Del.1984)). Also, in the pre-suit demand case of *Beam v. Stewart*, 833 A.2d 961 (Del.Ch.2003), the Court's independence analysis was informed by *Oracle*. *Id.* at 979.
- 53 845 A.2d 1040, 1055 (Del.2004) (internal citations omitted).

- 54 *Oracle*, 824 A.2d at 940.
- 55 The SLC Report did not reveal that Tyrrell extended the invitation to Vinter to join the iGov board. When Vinter was asked in his deposition how Tyrrell knew to call him, he initially stated “[y]ou’ll have to ask [Tyrrell] that. I don’t know.” Vinter Dep. 20:14-15, Oct. 7, 2009. Plaintiffs’ counsel then asked if Vinter knew who Tyrrell was when he called, to which Vinter responded “[w]ell, I mean, he’s my wife’s cousin” *Id.* at 20:20.
- 56 *Id.* at 947 (holding that independence under *Zapata* is not established where “the connections identified [between the SLC and the interested directors] would be on the mind of the SLC members in a way that generates an unacceptable risk of bias.”).
- 57 845 A.2d 1040, 1050 (Del.2004).
- 58 Vinter Aff. ¶¶ 2-3.
- 59 Vinter Dep. 21:3-4, Oct. 7, 2009.
- 60 Vice Chancellor Strine has made an important holding about the bearing of familial relationships on the independence inquiry. In a pre-suit demand case, plaintiff sought to carry its burden by alleging that a particular director was not independent, and could not impartially consider a demand, because he was the brother-in-law of an interested director. The Vice Chancellor held that “familial relationships between directors can create a reasonable doubt as to impartiality. The plaintiff bears no burden to plead facts demonstrating that directors who are closely related have no history of discord or enmity that renders the natural inference of mutual loyalty and affection unreasonable.” *Harbor Fin. Partners v. Huizenga*, 751 A.2d 879, 889 (Del.Ch.1999) (internal citations omitted). Thus, in the pre-suit demand context, plaintiffs can often meet their burden of establishing a lack of independence with a simple allegation of a familial relationship. Surely then, in the *Zapata* context, it will be nigh unto impossible for a corporation bearing the burden of proof to demonstrate that an SLC member is independent in the face of plaintiffs’ allegation that the SLC member and a director defendant have a family relationship.
- 61 Salvatori Dep. 29:3-5, Oct. 6, 2009.
- 62 *Oracle*, 824 A.2d at 938-39.
- 63 *Id.*
- 64 Pls.’ Answer Ex. 40.
- 65 Pls.’ Answer Ex. 41 (audit committee minutes from October 29, 2007 meeting).
- 66 Salvatori Dep. 248:8-9, Oct. 6, 2009.
- 67 *Id.* at 248:10-11.
- 68 *Id.* at 248:12-13.
- 69 Pls.’ Answer Ex. 5 at 127.
- 70 Vinter Dep. 217:6-17, Oct. 7, 2009.
- 71 Salvatori and Vinter had more than an entire year to mull over the merits of plaintiffs’ suit before the SLC was formed and they began their investigation.
- 72 *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917, 940 (Del.Ch.2003).
- 73 *Lewis v. Fuqua*, 502 A.2d 962, 967 (Del.Ch.1985) (“I find that the [SLC] addressed all the issues presented in the complaint and researched an additional issue of whether the Company’s directors had a personal interest in the challenged transaction. The investigation spanned four and a half months and was thorough and exhaustive as to all possible claims for recovery. I therefore find that the investigation conducted by the [SLC] was reasonable.”).
- 74 *See Kaplan v. Wyatt*, 499 A.2d 1184, 1190-91 (Del.1985).
- 75 *Sutherland v. Sutherland*, 958 A.2d 235, 242 (holding that there was a material doubt as to the reasonableness and good faith of an SLC’s investigation where the SLC’s report did not include an analysis of two large payments the corporation had made on the defendants’ behalf, even though the complaint alleged that defendants had used corporate funds for personal benefit).
- 76 *Electra Inv. Trust PLC v. Crews*, 1999 WL 135239, at *4 (Del.Ch. Feb.24, 1999).
- 77 *Id.* (holding that an SLC’s failure to explore a \$2,600 secondary dispute on cost-benefit grounds cast doubt on the SLC’s investigation because a minimal investigation might have provided the SLC with facts that would have helped it better evaluate the merits of the larger primary dispute).
- 78 *Id.* at *5.
- 79 *Lewis v. Fuqua*, 502 A.2d 962, 968-70 (Del.Ch.1985) (holding that an SLC did not have a reasonable basis for its dismissal recommendation because it had incorrectly concluded that the business judgment rule applied to the challenged transactions).
- 80 *Id.* at 968 (holding that an SLC did not have a reasonable basis for its dismissal recommendation because it had incorrectly assumed in its report that the board had rejected a corporate opportunity when, in fact, it was undisputed that the board had never formally rejected the opportunity).
- 81 The full § 102(b)(7) provision reads:

A director of the corporation shall not be personally liable to the corporation or its stockholders *for monetary damages* for breach of fiduciary duty as a director, except for liability (i) for any breach of the director's duty of loyalty to the Corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under Section 174 of the Delaware General Corporation Law; or (iv) *for any transaction from which the director derived an improper personal benefit*. If the Delaware General Corporation Law is amended to authorize corporate action further eliminating or limiting the personal liability of directors, then the liability of a director of the corporation shall be eliminated or limited to the fullest extent permitted by the Delaware General Corporation Law, as so amended (emphasis added).

82 BALOTTI & FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS § 4.15[C]
(3d. ed.2009); *Arnold v. Soc'y for Sav. Bancorp, Inc.*, 678 A.2d 533, 542 (Del.1996).

83 I also note that iGov's § 102(b)(7) provision might not even protect defendants against liability for monetary damages because the provision makes an exception for "any transaction from which the director derived an improper personal benefit." See n. 79 above. Plaintiffs' complaint alleges that defendants were able to obtain iGov stock for themselves at an artificially low price as a result of breaching their duty of care. Thus, the exculpatory clause might not apply to adoption of the 2007 Plan. The SLC failed to address this issue in the SLC Report. For the moment, I make no finding on whether the exculpatory clause would or would not apply to adoption of the 2007 Plan. I simply mention this to highlight that it was not considered by the SLC.

84 *Kaplan v. Wyatt*, 484 A.2d 501, 508 (Del.Ch.1984).

85 SLC Report 40-41 (emphasis added); see also *id.* 25 ("The [SLC] determined that the crux of the Derivative Complaint goes to the allegation that Tyrrell manipulated the information he was providing to Chessicap so as to depress the value of the Company"); *id.* 60 ("Plaintiffs' only meaningful attack on the procedural process through which the 2007 Plan was adopted is focused on their belief that Mike Tyrrell deliberately supplied Chessicap (sic) with overly pessimistic financial data for iGov").

86 SLC Report 41 (emphasis added).

87 SLC Report 61 (emphasis added).

88 SLC Report 42-43.

89 SLC Report 61. This inconsistency is problematic for the SLC because its finding that Tyrrell regularly prepared multiple forecasts for different purposes was critical to its conclusion that it was acceptable for him to provide different forecasts to Chessicap and Textron. The SLC's ultimate conclusion is undermined by this inconsistency.

90 The Third Textron Forecast showed an EBITDA that was 60% higher than the Revised Chessicap Forecast.

91 Presumably Textron would have been less willing to lend iGov money if Tyrrell sent them the Revised Chessicap Forecast.

92 This evidence is outlined in Part I-J of this Opinion.

93 See part I-J of this Opinion describing communications from management other than Tyrrell indicating a belief that an EBITDA of \$3 million or more was realistic.

94 *Lewis v. Fuqua*, 502 A.2d 962, 967 (Del.Ch.1985). In their depositions, Salvatori and Vinter testified that they did not recall whether they investigated the allegation that the Revised Chessicap Forecast failed to reflect the increased profitability in the TACLAN contract. Salvatori Dep. 207:19-20, Oct. 6, 2009; Vinter Dep. 95:14, Oct. 7, 2009. Salvatori admitted that knowing whether TACLAN had a large backorder would have been relevant, but he could not say what the SLC did to investigate this allegation. Salvatori Dep. 208:15-16.

95 *Electra Inv. Trust PLC v. Crews*, 1999 WL 135239, at *4 (Del.Ch. Feb.24, 1999).

96 SLC Report 23.

97 For example, the SLC's interview notes indicate that Neven and Hupalo both made statements to the SLC that it was their goal to sell or merge the Company. Pls.' Answer Ex. 5 at 38, 47. Similarly, Mr. Tyrrell told Chessicap in an email dated September 19, 2006 that "[t]here are very few people here with knowledge of our plan to sell in 2 or 3 years...." *Id.* Ex. 55.

98 SLC Report 24.

99 See *Lewis v. Fuqua*, 502 A.2d 962, 968 (Del.Ch.1985).

100 Pls.' Answer Ex. 56.

101 *Id.* Exs. 57, 58.

102 For example, at one point in the SLC Report the SLC speculates that the adoption of the 2007 Plan might actually be subject to business judgment review, rather than entire fairness review. The SLC bases this conclusion on the theory that the option grants and direct share purchases under the 2007 Plan might not have been "material" to defendants. Of course, this speculation is irrelevant because defendants stood on both sides of the transaction in adopting the 2007 Plan and entire fairness review would thus apply regardless of whether the options and direct share purchases were "material" to defendants. *London v. Tyrrell*, 2008 WL 2505435, at *5 (Del.Ch. June 24, 2008) (citing *Orman v. Cullman*, 794 A.2d 2, 25 n. 50 (Del. Ch.2002)). But in speculating as to materiality

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the SLC failed to conduct any investigation into the net worth or income of defendants so it had no basis in any event upon which to conclude that the options and direct share purchases might not have been “material.”

103 SLC Report 47.

104 SLC Report 50.

105 SLC Report 21.

106 *Electra Inv. Trust PLC v. Crews*, 1999 WL 135239, at *5 (Del.Ch. Feb.24, 1999).

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430 A.2d 779
Supreme Court of Delaware.

ZAPATA CORPORATION,
Defendant Below, Appellant,

v.

William MALDONADO, Plaintiff Below, Appellee.

Submitted Dec. 31, 1980 *.

| Decided May 13, 1981.

Stockholder instituted derivative action, on behalf of corporation, to recover against ten officers and/or directors on theory there had been breaches of fiduciary duty. The Court of Chancery denied corporation's alternative motions to dismiss complaint or for summary judgment, and corporation took interlocutory appeal. The Supreme Court, Quillen, J., held that: (1) even though demand was not made on board of directors to sue and the initial decision of whether to litigate was not placed before the board, it retained all of its corporate power concerning litigation decisions; (2) self-interest taint of majority of the board was not per se a bar to delegation of board's power over litigation decisions to independent committee composed of two disinterested board members; and (3) in ruling on the motions, Court of Chancery was to inquire into independence and good faith of the committee and the bases supporting its conclusions, and, if independence and good faith were found, Court was to exercise its own independent business judgment in determining whether a motion should be granted.

Reversed and remanded.

*780 Upon appeal from the Court of Chancery. Reversed and Remanded.

Attorneys and Law Firms

Robert K. Payson, (argued) of Potter, Anderson & Corroon, Wilmington, and Thomas F. Curnin, Thomas J. Kavalier, P. Kevin Castel and Edward P. Krugman of Cahill, Gordon & Reindel, New York City, of counsel, for defendant-appellant.

Charles F. Richards, Jr. of Richards, Layton & Finger, Wilmington, for individual defendants.

Irving Morris and Joseph A. Rosenthal of Morris & Rosenthal, Wilmington, Sidney L. Garwin (argued), and Bruce E. Gerstein of Garwin, Bronzaft & Gerstein, New York City, of counsel, for plaintiff-appellee.

Arthur G. Connolly, Jr. of Connolly, Bove & Lodge, Wilmington, for amici curiae.

Before DUFFY, QUILLEN and HORSEY, JJ.

Opinion

QUILLEN, Justice:

This is an interlocutory appeal from an order entered on April 9, 1980, by the Court of Chancery denying appellant-defendant Zapata Corporation's (Zapata) alternative motions to dismiss the complaint or for summary judgment. The issue to be addressed has reached this Court by way of a rather convoluted path.

In June, 1975, William Maldonado, a stockholder of Zapata, instituted a derivative action in the Court of Chancery on behalf of Zapata against ten officers and/or directors of Zapata, alleging, essentially, breaches of fiduciary duty. Maldonado did not first demand that the board bring this action, stating instead such demand's futility because all directors were named as defendants and allegedly participated in the acts specified.¹ In June, 1977, Maldonado commenced an action in the United States District Court for the Southern District of New York against the same defendants, save one, alleging federal security law violations as well as the same common law claims made previously in the Court of Chancery.

*781 By June, 1979, four of the defendant-directors were no longer on the board, and the remaining directors appointed two new outside directors to the board. The board then created an "Independent Investigation Committee" (Committee), composed solely of the two new directors, to investigate Maldonado's actions, as well as a similar derivative action then pending in Texas, and to determine whether the corporation should continue any or all of the litigation. The Committee's determination was stated to be "final, ... not ... subject to review by the Board of Directors and ... in all respects ... binding upon the Corporation."

Following an investigation, the Committee concluded, in September, 1979, that each action should "be dismissed forthwith as their continued maintenance is inimical to the Company's best interests" Consequently, Zapata moved for dismissal or summary judgment in the three derivative actions. On January 24, 1980, the District Court for the Southern District of New York granted Zapata's motion for summary judgment, Maldonado v. Flynn, S.D.N.Y., 485

F.Supp. 274 (1980), holding, under its interpretation of Delaware law, that the Committee had the authority, under the “business judgment” rule, to require the termination of the derivative action. Maldonado appealed that decision to the Second Circuit Court of Appeals.

On March 18, 1980, the Court of Chancery, in a reported opinion, the basis for the order of April 9, 1980, denied Zapata's motions, holding that Delaware law does not sanction this means of dismissal. More specifically, it held that the “business judgment” rule is not a grant of authority to dismiss derivative actions and that a stockholder has an individual right to maintain derivative actions in certain instances. *Maldonado v. Flynn*, Del.Ch., 413 A.2d 1251 (1980) (herein Maldonado). Pursuant to the provisions of Supreme Court Rule 42, Zapata filed an interlocutory appeal with this Court shortly thereafter. The appeal was accepted by this Court on June 5, 1980. On May 29, 1980, however, the Court of Chancery dismissed Maldonado's cause of action, its decision based on principles of *res judicata*, expressly conditioned upon the Second Circuit affirming the earlier New York District Court's decision.² The Second Circuit appeal was ordered stayed, however, pending this Court's resolution of the appeal from the April 9th Court of Chancery order denying dismissal and summary judgment.

[1] Thus, Zapata's observation that it sits “in a procedural gridlock” appears quite accurate, and we agree that this Court can and should attempt to resolve the particular question of Delaware law.³ As the Vice Chancellor noted, 413 A.2d at 1257, “it is the law of the State of incorporation which determines whether the directors have this power of dismissal, *Burks v. Lasker*, 441 U.S. 471, 99 S.Ct. 1831, 60 L.Ed.2d 404 (1979)”. We limit our review in this interlocutory appeal to whether the Committee has the power to cause the present action to be dismissed.

We begin with an examination of the carefully considered opinion of the Vice Chancellor which states, in part, that the “business judgment” rule does not confer power “to a corporate board of directors to terminate a derivative suit”, 413 A.2d at 1257. His conclusion is particularly pertinent because several federal courts, applying Delaware law, have held that the business judgment rule enables boards (or their committees) to terminate derivative suits, decisions now in conflict with the holding below.⁴

*782 As the term is most commonly used, and given the disposition below, we can understand the Vice Chancellor's comment that “the business judgment rule is irrelevant to

the question of whether the Committee has the authority to compel the dismissal of this suit”. 413 A.2d at 1257. Corporations, existing because of legislative grace, possess authority as granted by the legislature. Directors of Delaware corporations derive their managerial decision making power, which encompasses decisions whether to initiate, or refrain from entering, litigation,⁵ from 8 Del.C. s 141 (a).⁶ This statute is the fount of directorial powers. The “business judgment” rule is a judicial creation that presumes propriety, under certain circumstances, in a board's decision.⁷ Viewed defensively, it does not create authority. In this sense the “business judgment” rule is not relevant in corporate decision making until after a decision is made. It is generally used as a defense to an attack on the decision's soundness. The board's managerial decision making power, however, comes from s 141(a). The judicial creation and legislative grant are related because the “business judgment” rule evolved to give recognition and deference to directors' business expertise when exercising their managerial power under s 141(a).

In the case before us, although the corporation's decision to move to dismiss or for summary judgment was, literally, a decision resulting from an exercise of the directors' (as delegated to the Committee) business judgment, the question of “business judgment”, in a defensive sense, would not become relevant until and unless the decision to seek termination of the derivative lawsuit was attacked as improper. Maldonado, 413 A.2d at 1257. Accord, *Abella v. Universal Leaf Tobacco Co., Inc.*, E.D.Va., 495 F.Supp. 713 (1980) (applying Virginia law); *Maier v. Zapata Corp.*, S.D.Tex., 490 F.Supp. 348 (1980) (applying Delaware law). See also, *Dent*, supra note 5, 75 Nw.U.L.Rev. at 101-02, 135. This question was not reached by the Vice Chancellor because he determined that the stockholder had an individual right to maintain this derivative action. Maldonado, 413 A.2d at 1262.

Thus, the focus in this case is on the power to speak for the corporation as to whether the lawsuit should be continued or terminated. As we see it, this issue in the current appellate posture of this case has three aspects: the conclusions of the Court below concerning the continuing right of a stockholder to maintain a derivative action; the corporate power under Delaware law of an authorized board committee to cause dismissal of litigation instituted for the benefit of the corporation; and the role of the Court of Chancery in resolving conflicts between the stockholder and the committee.

Accordingly, we turn first to the Court of Chancery's conclusions concerning the right of a plaintiff stockholder

in a derivative action. We find that its determination that a stockholder, once demand is made and refused, possesses an independent, individual right to continue a derivative suit for breaches of fiduciary duty over objection by the corporation, Maldonado, 413 A.2d at 1262-63, as an absolute rule, is erroneous. The Court of Chancery relied principally upon *783 *Sohland v. Baker*, Del.Supr., 141 A. 277 (1927), for this statement of the Delaware rule. Maldonado, 413 A.2d at 1260-61. *Sohland* is sound law. But *Sohland* cannot be fairly read as supporting the broad proposition which evolved in the opinion below.

In *Sohland*, the complaining stockholder was allowed to file the derivative action in equity after making demand and after the board refused to bring the lawsuit. But the question before us relates to the power of the corporation by motion to terminate a lawsuit properly commenced by a stockholder without prior demand. No Delaware statute or case cited to us directly determines this new question and we do not think that *Sohland* addresses it by implication.

The language in *Sohland* relied on by the Vice Chancellor negates the contention that the case stands for the broad rule of stockholder right which evolved below. This Court therein stated that "a stockholder may sue in his own name for the purpose of enforcing corporate rights ... in a proper case if the corporation on the demand of the stockholder refuses to bring suit." 141 A. at 281 (emphasis added). The Court also stated that "whether ('')he right of a stockholder to file a bill to litigate corporate rights") exists necessarily depends on the facts of each particular case." 141 A. at 282 (emphasis added). Thus, the precise language only supports the stockholder's right to initiate the lawsuit. It does not support an absolute right to continue to control it.

Additionally, the issue and context in *Sohland* are simply different from this case. Baker, a stockholder, suing on behalf of Bankers' Mortgage Co., sought cancellation of stock issued to *Sohland*, a director of Bankers', in a transaction participated in by a "great majority" of Bankers' board. Before instituting his suit, Baker requested the board to assert the cause of action. The board refused. Interestingly, though, on the same day the board refused, it authorized payment of Baker's attorneys fees so that he could pursue the claim; one director actually escorted Baker to the attorneys suggested by the board. At this chronological point, *Sohland* had resigned from the board, and it was he, not the board, who was protesting Baker's ability to bring suit. In sum, despite the board's refusal to bring suit, it is clear that the board supported Baker in his efforts.⁸ It is not surprising then that he was allowed to

proceed as the corporation's representative "for the prevention of injustice", because "the corporation itself refused to litigate an apparent corporate right." 141 A. at 282.

Moreover, *McKee v. Rogers*, Del.Ch., 156 A. 191 (1931), stated "as a general rule" that "a stockholder cannot be permitted ... to invade the discretionary field committed to the judgment of the directors and sue in the corporation's behalf when the managing body refuses. This rule is a well settled one." 156 A. at 193.⁹

[2] The *McKee* rule, of course, should not be read so broadly that the board's refusal will be determinative in every instance. Board members, owing a well-established fiduciary duty to the corporation, will not be allowed to cause a derivative suit to be dismissed when it would be a breach of their fiduciary duty. Generally *784 disputes pertaining to control of the suit arise in two contexts.

[3] Consistent with the purpose of requiring a demand, a board decision to cause a derivative suit to be dismissed as detrimental to the company, after demand has been made and refused, will be respected unless it was wrongful.¹⁰ See, e. g., *United Copper Securities Co. v. Amalgamated Copper Co.*, 244 U.S. 261, 263-64, 37 S.Ct. 509, 510, 61 L.Ed. 1119, 1124 (1917); *Stockholder Derivative Actions*, supra note 5, 44 U.Chi.L.Rev. at 169, 191-92; Note, *Demand on Directors and Shareholders as a Prerequisite to a Derivative Suit*, 73 Har.L.Rev. 746, 748, 759 (1960); 13 W. Fletcher, *Cyclopedia of the Law of Private Corporations* s 5969 (rev.perm.ed. 1980). A claim of a wrongful decision not to sue is thus the first exception and the first context of dispute. Absent a wrongful refusal, the stockholder in such a situation simply lacks legal managerial power. Compare Maldonado, 413 A.2d at 1259-60.

[4] But it cannot be implied that, absent a wrongful board refusal, a stockholder can never have an individual right to initiate an action. For, as is stated in *McKee*, a "well settled" exception exists to the general rule.

"(A) stockholder may sue in equity in his derivative right to assert a cause of action in behalf of the corporation, without prior demand upon the directors to sue, when it is apparent that a demand would be futile, that the officers are under an influence that sterilizes discretion and could not be proper persons to conduct the litigation."

156 A. at 193 (emphasis added). This exception, the second context for dispute, is consistent with the Court of Chancery's statement below, that "(t) he stockholders' individual right to bring the action does not ripen, however, ... unless he can show a demand to be futile." Maldonado, 413 A.2d at 1262.
11

These comments in McKee and in the opinion below make obvious sense. A demand, when required and refused (if not wrongful), terminates a stockholder's legal ability to initiate a derivative action.¹² But where demand is properly excused, the stockholder does possess the ability to initiate the action on his corporation's behalf.

[5] These conclusions, however, do not determine the question before us. Rather, they merely bring us to the question to be decided. It is here that we part company with the Court below. Derivative suits enforce corporate rights and any recovery obtained goes to the corporation. *Taormina v. Taormina Corp.*, Del.Ch., 78 A.2d 473, 476 (1951); *Keenan v. Eshleman*, Del.Supr., 2 A.2d 904, 912-13 (1938). "The right of a stockholder to file a bill to litigate corporate rights is, therefore, solely for the purpose of preventing injustice where it is apparent that material corporate rights would not otherwise be protected." *Sohland*, 141 A. at 282. We see no inherent reason why the "two phases" of a derivative suit, the stockholder's suit to compel the corporation to sue and the corporation's suit (see 413 A.2d at 1261-62), should automatically result in the placement in the hands of the *785 litigating stockholder sole control of the corporate right throughout the litigation. To the contrary, it seems to us that such an inflexible rule would recognize the interest of one person or group to the exclusion of all others within the corporate entity. Thus, we reject the view of the Vice Chancellor as to the first aspect of the issue on appeal.

The question to be decided becomes: When, if at all, should an authorized board committee be permitted to cause litigation, properly initiated by a derivative stockholder in his own right, to be dismissed? As noted above, a board has the power to choose not to pursue litigation when demand is made upon it, so long as the decision is not wrongful. If the board determines that a suit would be detrimental to the company, the board's determination prevails. Even when demand is excusable, circumstances may arise when continuation of the litigation would not be in the corporation's best interests. Our inquiry is whether, under such circumstances, there is a permissible procedure under s 141(a) by which a corporation can rid itself of detrimental litigation. If there is not, a single

stockholder in an extreme case might control the destiny of the entire corporation. This concern was bluntly expressed by the Ninth Circuit in *Lewis v. Anderson*, 9th Cir., 615 F.2d 778, 783 (1979), cert. denied, -- U.S. --, 101 S.Ct. 206, 66 L.Ed.2d 89 (1980): "To allow one shareholder to incapacitate an entire board of directors merely by leveling charges against them gives too much leverage to dissident shareholders." But, when examining the means, including the committee mechanism examined in this case, potentials for abuse must be recognized. This takes us to the second and third aspects of the issue on appeal.

[6] Before we pass to equitable considerations as to the mechanism at issue here, it must be clear that an independent committee possesses the corporate power to seek the termination of a derivative suit. Section 141(c) allows a board to delegate all of its authority to a committee.¹³ Accordingly, a committee with properly delegated authority would have the power to move for dismissal or summary judgment if the entire board did.

[7] Even though demand was not made in this case and the initial decision of whether to litigate was not placed before the board, Zapata's board, it seems to us, retained all of its corporate power concerning litigation decisions. If Maldonado had made demand on the board in this case, it could have refused to bring suit. Maldonado could then have asserted that the decision not to sue was wrongful and, if correct, would have been allowed to maintain the suit. The board, however, never would have lost its statutory managerial authority. The demand requirement itself evidences that the managerial power is retained *786 by the board. When a derivative plaintiff is allowed to bring suit after a wrongful refusal, the board's authority to choose whether to pursue the litigation is not challenged although its conclusion reached through the exercise of that authority is not respected since it is wrongful. Similarly, Rule 23.1, by excusing demand in certain instances, does not strip the board of its corporate power. It merely saves the plaintiff the expense and delay of making a futile demand resulting in a probable tainted exercise of that authority in a refusal by the board or in giving control of litigation to the opposing side. But the board entity remains empowered under s 141(a) to make decisions regarding corporate litigation. The problem is one of member disqualification, not the absence of power in the board.

[8] The corporate power inquiry then focuses on whether the board, tainted by the self-interest of a majority of its members, can legally delegate its authority to a committee of two

disinterested directors. We find our statute clearly requires an affirmative answer to this question. As has been noted, under an express provision of the statute, s 141(c), a committee can exercise all of the authority of the board to the extent provided in the resolution of the board. Moreover, at least by analogy to our statutory section on interested directors, 8 Del.C. s 141, it seems clear that the Delaware statute is designed to permit disinterested directors to act for the board.¹⁴ Compare *Puma v. Marriott*, Del.Ch., 283 A.2d 693, 695-96 (1971).

We do not think that the interest taint of the board majority is per se a legal bar to the delegation of the board's power to an independent committee composed of disinterested board members. The committee can properly act for the corporation to move to dismiss derivative litigation that is believed to be detrimental to the corporation's best interest.

Our focus now switches to the Court of Chancery which is faced with a stockholder assertion that a derivative suit, properly instituted, should continue for the benefit of the corporation and a corporate assertion, properly made by a board committee acting with board authority, that the same derivative suit should be dismissed as inimical to the best interests of the corporation.

At the risk of stating the obvious, the problem is relatively simple. If, on the one hand, corporations can consistently wrest bona fide derivative actions away from well-meaning derivative plaintiffs through the use of the committee mechanism, the derivative suit will lose much, if not all, of its generally-recognized effectiveness as an intra-corporate means of policing boards of directors. See *Dent*, supra note 5, 75 Nw.U.L.Rev. at 96 & n. 3, 144 & n. 241. If, on the other hand, corporations are unable to rid themselves of meritless or harmful litigation *787 and strike suits, the derivative action, created to benefit the corporation, will produce the opposite, unintended result. For a discussion of strike suits, see *Dent*, supra, 75 Nw.U.L.Rev. at 137. See also *Cramer v. General Telephone & Electronics Corp.*, 3d Cir., 582 F.2d 259, 275 (1978), cert. denied, 439 U.S. 1129, 99 S.Ct. 1048, 59 L.Ed.2d 90 (1979). It thus appears desirable to us to find a balancing point where bona fide stockholder power to bring corporate causes of action cannot be unfairly trampled on by the board of directors, but the corporation can rid itself of detrimental litigation.

As we noted, the question has been treated by other courts as one of the "business judgment" of the board committee. If a "committee, composed of independent and disinterested directors, conducted a proper review of the matters before

it, considered a variety of factors and reached, in good faith, a business judgment that (the) action was not in the best interest of (the corporation)", the action must be dismissed. See, e. g., *Maldonado v. Flynn*, supra, 485 F.Supp. at 282, 286. The issues become solely independence, good faith, and reasonable investigation. The ultimate conclusion of the committee, under that view, is not subject to judicial review.

We are not satisfied, however, that acceptance of the "business judgment" rationale at this stage of derivative litigation is a proper balancing point. While we admit an analogy with a normal case respecting board judgment, it seems to us that there is sufficient risk in the realities of a situation like the one presented in this case to justify caution beyond adherence to the theory of business judgment.

The context here is a suit against directors where demand on the board is excused. We think some tribute must be paid to the fact that the lawsuit was properly initiated. It is not a board refusal case. Moreover, this complaint was filed in June of 1975 and, while the parties undoubtedly would take differing views on the degree of litigation activity, we have to be concerned about the creation of an "Independent Investigation Committee" four years later, after the election of two new outside directors. Situations could develop where such motions could be filed after years of vigorous litigation for reasons unconnected with the merits of the lawsuit.

Moreover, notwithstanding our conviction that Delaware law entrusts the corporate power to a properly authorized committee, we must be mindful that directors are passing judgment on fellow directors in the same corporation and fellow directors, in this instance, who designated them to serve both as directors and committee members. The question naturally arises whether a "there but for the grace of God go I" empathy might not play a role. And the further question arises whether inquiry as to independence, good faith and reasonable investigation is sufficient safeguard against abuse, perhaps subconscious abuse.

There is another line of exploration besides the factual context of this litigation which we find helpful. The nature of this motion finds no ready pigeonhole, as perhaps illustrated by its being set forth in the alternative. It is perhaps best considered as a hybrid summary judgment motion for dismissal because the stockholder plaintiff's standing to maintain the suit has been lost. But it does not fit neatly into a category described in Rule 12(b) of the Court of Chancery Rules nor does it correspond directly with Rule 56 since the question of

genuine issues of fact on the merits of the stockholder's claim are not reached.

It seems to us that there are two other procedural analogies that are helpful in addition to reference to Rules 12 and 56. There is some analogy to a settlement in that there is a request to terminate litigation without a judicial determination of the merits. See *Perrine v. Pennroad Corp.*, Del.Supr., 47 A.2d 479, 487 (1946). "In determining whether or not to approve a proposed settlement of a derivative stockholders' action (when directors are on both sides of the transaction), the Court of Chancery is called upon to exercise its own business judgment." *Neponsit Investment Co. v. Abramson*, Del.Supr., 405 A.2d 97, 100 (1979) and cases therein cited. In this case, *788 the litigating stockholder plaintiff facing dismissal of a lawsuit properly commenced ought, in our judgment, to have sufficient status for strict Court review.

Finally, if the committee is in effect given status to speak for the corporation as the plaintiff in interest, then it seems to us there is an analogy to Court of Chancery Rule 41(a)(2) where the plaintiff seeks a dismissal after an answer. Certainly, the position of record of the litigating stockholder is adverse to the position advocated by the corporation in the motion to dismiss. Accordingly, there is perhaps some wisdom to be gained by the direction in Rule 41(a)(2) that "an action shall not be dismissed at the plaintiff's instance save upon order of the Court and upon such terms and conditions as the Court deems proper."

Whether the Court of Chancery will be persuaded by the exercise of a committee power resulting in a summary motion for dismissal of a derivative action, where a demand has not been initially made, should rest, in our judgment, in the independent discretion of the Court of Chancery. We thus steer a middle course between those cases which yield to the independent business judgment of a board committee and this case as determined below which would yield to unbridled plaintiff stockholder control. In pursuit of the course, we recognize that "(t)he final substantive judgment whether a particular lawsuit should be maintained requires a balance of many factors ethical, commercial, promotional, public relations, employee relations, fiscal as well as legal." *Maldonado v. Flynn*, supra, 485 F.Supp. at 285. But we are content that such factors are not "beyond the judicial reach" of the Court of Chancery which regularly and competently deals with fiduciary relationships, disposition of trust property, approval of settlements and scores of similar problems. We recognize the danger of judicial overreaching but the alternatives seem to us to be outweighed by the fresh view

of a judicial outsider. Moreover, if we failed to balance all the interests involved, we would in the name of practicality and judicial economy foreclose a judicial decision on the merits. At this point, we are not convinced that is necessary or desirable.

[9] After an objective and thorough investigation of a derivative suit, an independent committee may cause its corporation to file a pretrial motion to dismiss in the Court of Chancery. The basis of the motion is the best interests of the corporation, as determined by the committee. The motion should include a thorough written record of the investigation and its findings and recommendations. Under appropriate Court supervision, akin to proceedings on summary judgment, each side should have an opportunity to make a record on the motion. As to the limited issues presented by the motion noted below, the moving party should be prepared to meet the normal burden under Rule 56 that there is no genuine issue as to any material fact and that the moving party is entitled to dismiss as a matter of law.¹⁵ The Court should apply a two-step test to the motion.

[10] First, the Court should inquire into the independence and good faith of the committee and the bases supporting its conclusions. Limited discovery may be ordered to facilitate such inquiries.¹⁶ The corporation should have the burden of proving independence, good faith and a reasonable investigation, rather than presuming independence, good faith and reasonableness.¹⁷ *789 If the Court determines either that the committee is not independent or has not shown reasonable bases for its conclusions, or, if the Court is not satisfied for other reasons relating to the process, including but not limited to the good faith of the committee, the Court shall deny the corporation's motion. If, however, the Court is satisfied under Rule 56 standards that the committee was independent and showed reasonable bases for good faith findings and recommendations, the Court may proceed, in its discretion, to the next step.

The second step provides, we believe, the essential key in striking the balance between legitimate corporate claims as expressed in a derivative stockholder suit and a corporation's best interests as expressed by an independent investigating committee. The Court should determine, applying its own independent business judgment, whether the motion should be granted.¹⁸ This means, of course, that instances could arise where a committee can establish its independence and sound bases for its good faith decisions and still have the corporation's motion denied. The second step is intended to

thwart instances where corporate actions meet the criteria of step one, but the result does not appear to satisfy its spirit, or where corporate actions would simply prematurely terminate a stockholder grievance deserving of further consideration in the corporation's interest. The Court of Chancery of course must carefully consider and weigh how compelling the corporate interest in dismissal is when faced with a non-frivolous lawsuit. The Court of Chancery should, when appropriate, give special consideration to matters of law and public policy in addition to the corporation's best interests.

If the Court's independent business judgment is satisfied, the Court may proceed to grant the motion, subject, of course, to any equitable terms or conditions the Court finds necessary or desirable.

The interlocutory order of the Court of Chancery is reversed and the cause is remanded for further proceedings consistent with this opinion.

Parallel Citations

22 A.L.R.4th 1190

Footnotes

- * The appeal was argued on Oct. 16, 1980 but certain procedural matters required by this Court were not accomplished until the date indicated.
- 1 Court of Chancery Rule 23.1 states in part: "The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority and the reasons for his failure to obtain the action or for not making the effort."
- 2 Maldonado v. Flynn, Del.Ch., 417 A.2d 378 (1980). Proceedings in the Trial Court are not automatically stayed during the pendency of an interlocutory appeal. Supreme Court Rule 42(d).
- 3 The District Court for the Southern District of Texas, in *Maier v. Zapata Corp.*, S.D.Tex., 490 F.Supp. 348 (1980), denied Zapata's motions to dismiss or for summary judgment in an opinion consistent with Maldonado.
- 4 *Abbey v. Control Data Corp.*, 8th Cir., 603 F.2d 724 (1979), cert. denied, 444 U.S. 1017, 100 S.Ct. 670, 62 L.Ed.2d 647 (1980); *Lewis v. Adams*, N.D.Okla., No. 77-266C (November 15, 1979); *Siegal v. Merrick*, S.D.N.Y., 84 F.R.D. 106 (1979); and, of course, *Maldonado v. Flynn*, S.D.N.Y., 485 F.Supp. 274 (1980). See also *Abramowitz v. Posner*, S.D.N.Y., 513 F.Supp. 120, (1981) which specifically rejected the result reached by the Vice Chancellor in this case.
- 5 See Dent, *The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit?* 75 Nw.U.L.Rev. 96, 98 & n. 14 (1980); Comment, *The Demand and Standing Requirements in Stockholder Derivative Actions*, 44 U.Chi.L.Rev. 168, 192 & nn. 153-54 (1976) (herein *Stockholder Derivative Actions*).
- 6 8 Del.C. s 141(a) states:
"The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation. If any such provision is made in the certificate of incorporation, the powers and duties conferred or imposed upon the board of directors by this chapter shall be exercised or performed to such extent and by such person or persons as shall be provided in the certificate of incorporation."
- 7 See Arsh, *The Business Judgment Rule Revisited*, 8 Hofstra L.Rev. 93, 97, 130-33 (1979).
- 8 Compare *Baker v. Bankers' Mortgage Co.*, Del.Ch., 129 A. 775, 776-77 (1925), the lower *Sohland*. In *Baker*, Chancellor Wolcott posed a rhetorical question that is entirely consistent with the result we reach today: "(W)hy should not a stockholder, if the managing body absolutely refuses to act, be permitted to assert on behalf of himself and other stockholders a complaint, not against matters lying in sound discretion and honest judgment, but against frauds perpetrated by an officer in clear breach of his trust?" 129 A. at 777.
- 9 To the extent that *Mayer v. Adams*, Del.Supr., 141 A.2d 458, 462 (1958) and *Ainscow v. Sanitary Co. of America*, Del.Ch., 180 A. 614, 615 (1935), relied upon in Maldonado, 413 A.2d at 1262, contain language relating to the rule in *McKee*, we note that each decision is dissimilar from the one we examine today. *Mayer* held that demand on the stockholders was not required before maintaining a derivative suit if the wrong alleged could not be ratified by the stockholders. *Ainscow* found defective a complaint that neither alleged demand on the directors, nor reasons why demand was excusable.
- 10 In other words, when stockholders, after making demand and having their suit rejected, attack the board's decision as improper, the board's decision falls under the "business judgment" rule and will be respected if the requirements of the rule are met. See Dent, *supra* note 5, 75 Nw.U.L.Rev. at 100-01 & nn. 24-25. That situation should be distinguished from the instant case, where demand was not made, and the power of the board to seek a dismissal, due to disqualification, presents a threshold issue. For examples of what has

been held to be a wrongful decision not to sue, see *Stockholder Derivative Actions*, supra note 5, 44 U.Chi.L.Rev. at 193-98. We recognize that the two contexts can overlap in practice.

11 These statements are consistent with Rule 23.1's "reasons for ... failure" to make demand. See also the other cases cited by the Vice Chancellor, 413 A.2d at 1262: *Ainscow v. Sanitary Co. of America*, supra note 9, 180 A. at 615; *Mayer v. Adams*, supra note 9, 141 A.2d at 462; *Dann v. Chrysler Corp.*, Del.Ch., 174 A.2d 696, 699-700 (1961).

12 Even in this situation, it may take litigation to determine the stockholder's lack of power, i. e., standing.

13 8 Del.C. s 141(c) states:

"The board of directors may, by resolution passed by a majority of the whole board, designate 1 or more committees, each committee to consist of 1 or more of the directors of the corporation. The board may designate 1 or more directors as alternative members of any committee, who may replace any absent or disqualified member at any meeting of the committee. The bylaws may provide that in the absence or disqualification of a member of a committee, the member or members present at any meeting and not disqualified from voting, whether or not he or they constitute a quorum, may unanimously appoint another member of the board of directors to act at the meeting in the place of any such absent or disqualified member. Any such committee, to the extent provided in the resolution of the board of directors, or in the bylaws of the corporation, shall have and may exercise all the powers and authority of the board of directors in the management of the business and affairs of the corporation, and may authorize the seal of the corporation to be affixed to all papers which may require it; but no such committee shall have the power or authority in reference to amending the certificate of incorporation, adopting an agreement of merger or consolidation, recommending to the stockholders the sale, lease or exchange of all or substantially all of the corporation's property and assets, recommending to the stockholders a dissolution of the corporation or a revocation of a dissolution, or amending the bylaws of the corporation; and, unless the resolution, bylaws, or certificate of incorporation expressly so provide, no such committee shall have the power or authority to declare a dividend or to authorize the issuance of stock."

14 8 Del.C. s 144 states:

"s 144. Interested directors; quorum.

(a) No contract or transaction between a corporation and 1 or more of its directors or officers, or between a corporation and any other corporation, partnership, association, or other organization in which 1 or more of its directors or officers are directors or officers, or have a financial interest, shall be void or voidable solely for this reason, or solely because the director or officer is present at or participates in the meeting of the board or committee which authorizes the contract or transaction, or solely because his or their votes are counted for such purpose, if:

(1) The material facts as to his relationship or interest and as to the contract or transaction are disclosed or are known to the board of directors or the committee, and the board or committee in good faith authorizes the contract or transaction by the affirmative votes of a majority of the disinterested directors, even though the disinterested directors be less than a quorum; or

(2) The material facts as to his relationship or interest and as to the contract or transaction are disclosed or are known to the shareholders entitled to vote thereon, and the contract or transaction is specifically approved in good faith by vote of the shareholders; or

(3) The contract or transaction is fair to the corporation as of the time it is authorized, approved or ratified, by the board of directors, a committee, or the shareholders.

(b) Common or interested directors may be counted in determining the presence of a quorum at a meeting of the board of directors or of a committee which authorizes the contract or transaction."

15 We do not foreclose a discretionary trial of factual issues but that issue is not presented in this appeal. See *Lewis v. Anderson*, supra, 615 F.2d at 780. Nor do we foreclose the possibility that other motions may proceed or be joined with such a pretrial summary judgment motion to dismiss, e. g., a partial motion for summary judgment on the merits.

16 See, e. g., *Galef v. Alexander*, 2d Cir., 615 F.2d 51, 56 (1980); *Maldonado v. Flynn*, supra, 485 F.Supp. at 285-86; *Rosengarten v. International Telephone & Telegraph Corp.*, S.D.N.Y., 466 F.Supp. 817, 823 (1979); *Gall v. Exxon Corp.*, S.D.N.Y., 418 F.Supp. 508, 520 (1976). Compare *Dent*, supra note 5, 75 Nw.U.L.Rev. at 131-33.

17 Compare *Auerbach v. Bennett*, 47 N.Y.2d 619, 419 N.Y.S.2d 920, 928-29, 393 N.E.2d 994 (1979). Our approach here is analogous to and consistent with the Delaware approach to "interested director" transactions, where the directors, once the transaction is attacked, have the burden of establishing its "intrinsic fairness" to a court's careful scrutiny. See, e. g., *Sterling v. Mayflower Hotel Corp.*, Del.Supr., 93 A.2d 107 (1952).

18 This step shares some of the same spirit and philosophy of the statement by the Vice Chancellor: "Under our system of law, courts and not litigants should decide the merits of litigation." 413 A.2d at 1263.

Tab D

Special Litigation Committee Report

May 29, 2010

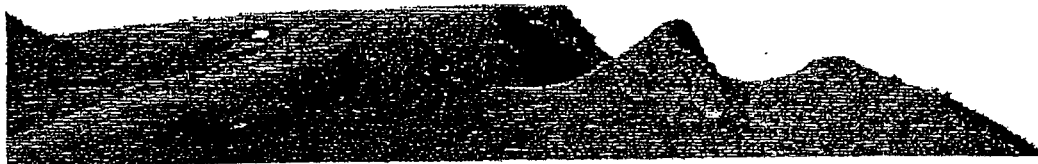
To: The Hi Country Estates Homeowners Association Board of Directors and Members

From: Kim Wilson, Chair, Special Litigation Committee

This report contains the results of inquiries into 1) the claim and demand set forth by Lindsay Atwood, Dave Moore, Tom Chace, Lenell Chace, Branden Frank and Jerry Gilmore in a letter to Hi Country Estates Phase II Homeowners Association dated June 12, 2009 and 2) the claim filed in Third District Court on November 25, 2009, Hi-Country Property Rights Group, Lindsay Atwood, Jerry Gilmore and Brandon Frank VS Keith Emmer, Tom Williams, Anthony Sarra, Arlene Johnson, Carol Dean and Hi Country Estates Homeowners Association, Phase II.

Special Litigation Committee Members:

Kim Wilson, Chair
Tony Sarra
Arlene P. Johnson



HCE00093

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I. Methodology

- A. During the fall of 2009, the Special Litigation Committee (SLC) members individually began reviewing the complaint documents, meeting minutes, governing documents, email communication, miscellaneous other communication, statistical data and past expenditures related to Hi Country Estates Phase II Homeowners' Association. (HCEII).
- B. The SLC asked Keith Emmer and the Architectural Control Committee (ACC) to print out emails and to collect any records relating the complaint. Their emails and other information are used as supporting documentation for this report.
- C. In November 2009 the SLC completed a study comparing the volume of traffic on different roads within the association with the amount of money spent on roads over the past fifteen years.¹
- D. It was determined by the SLC that information gleaned from interviewing members of the association would be an important element in determining if there was evidence supporting the plaintiffs' claims.² A postcard was mailed on February 9, 2010 to everyone owning property in Hi Country Estates Phase II. The content of the postcard read as follows:

Dear HCII Member,

A group of HCII property owners has recently asserted certain claims regarding the board of director's decisions regarding road maintenance and improvement, snow removal, livestock housing and management policies in connection with greenbelt tax status and whether or not a member who does not own a home in HCII is eligible to serve as a member of the board of directors. For information on the claim and to review the demand letter, go to the HCII website www.hi-country2.com

Pursuant to Utah law, the board has appointed a special litigation committee to investigate these claims and demands to determine if they have merit. In an effort to obtain as much information on these issues as is possible, we are inviting property owners to meet with the special litigation committee to discuss these issues. We plan to be available for these interviews on: March 16 and March 17, 6 p.m. to 9 p.m. If you have information regarding these claims and are willing to discuss that information with us, please call Kim Wilson, Chairperson of the Committee, at 801-571-5490 to arrange an appointment. Leave a message and your call will be returned.

We appreciate your participation.

Kim Wilson, Chair Special Litigation Committee

¹ Various Documents HCEII, Hi-Country II Road Maintenance Patterns 1994 – 2009, Pages 99-104

² Special Litigation Committee Interviews, Plaintiffs, Kim Wilson informed the plaintiffs that the SLC is trying to get their support for the claim, Page 2, Line 74

- E. Select individuals were contacted by telephone for interviews. They included:
 - 1. Keith Emmer, President of Hi Country Estates II
 - 2. Rex Facer, Road grading and snow removal contractor
 - 3. Terri Williams, Architectural Control Committee
 - 4. Walter and Ronna Hoffman, Former Chair of the Greenbelt Committee and former owners of Lindsey Attwood's property
 - 5. Tom Chace, Chair of the Greenbelt/ Property Rights Committee. He declined the interview.³
 - 6. Lindsay Atwood declined then later agreed to meet with the committee but only if accompanied with Jerry Gilmore, Brandon Frank and their attorney, Wade Budge.
- F. Individuals were contacted to answer written questions. They included:
 - 1. Susan Yoshinaga, Salt Lake County Assessor's Office⁴
 - 2. Cal Schneller, Former Director of Salt Lake County Development Services⁵
 - 3. Tom Williams, Board Member⁶
- G. In response to the postcard sent on February 9, 2010, four HCEII members contacted the Special Litigation Committee for Interviews: (One did not show up for the interview)
 - 1. Richard and Dorothy Mittlestaedt, residents located on Rose Canyon Road
 - 2. Robert Messmer, resident located on a HCEII maintained road.
- H. The SLC identified and listed claims as they understood them from the June 12, 2009 demand letter and the complaint document. Using the data available to them, they attempted to find facts that would either validate or invalidate claims.
 - 1. The plaintiffs are listed in the claim as Hi-Country Property Rights Group, Lindsay Atwood, Brandon Frank and Jerry Gilmore. Tom and Lenell Chace and Dave Moore are included with the three plaintiffs in the June 12, 2009 Demand letter. The plaintiffs are part of the Property Rights/ Greenbelt Committee⁷ and Tom Chace is the leader of the Property Rights/ Greenbelt Committee⁸. No other names of plaintiffs were given to the SLC by the plaintiffs or their Attorney but they stated that there were 29 members of their legal litigation committee.¹⁰
 - 2. The Special Litigation Committee did not explore annexation to the sewer district and the installation of sewer because these items were not included in the complaint.
 - 3. Annexation into Herriman and the Salt Lake County Foothills and Canyons Overlay Zone (FCOZ) are mentioned in several of Tom Chace's emails. FCOZ is a Salt Lake County zone and annexation to Herriman is addressed where it was offered by the plaintiffs and Tom Chace as a way to avoid filing the claim.
- I. This report is the result of the Special Litigation Committee's findings.

³ Various Documents HCEII, Notes from telephone conversation between Arlene Johnson and Tom Chace. 2/10-12/10 Tom felt that the Committee was not independent and they were collecting information for their Attorney and for their own defense, February 10, 2010, Page 106

⁴ Various Documents HCEII, Notes from Communication between Arlene Johnson and Susan Yoshinaga regarding Greenbelt, March 3 & 17, 2010, Pages 109-110

⁵ Various Documents HCEII, Notes from Communication between Arlene Johnson and Cal Schneller, Mr. Schneller regarding subdivisions and the Foothill and Canyons Overlay Zone (FCOZ), March 10 & 23, 2010, Pages 111-114

⁶ Various Documents HCE II, Letter from Tom Williams to HCEII HOA regarding distributing gate keys, March 6, 2010, Page 108

⁷ Keith Emmer's Emails, Tom & Lenell Chace to Keith Emmer, August 18, 2008, Page 7 & 8

⁸ Keith Emmer's Emails, Tom & Lenell Chace to Keith Emmer, September 19, 2008, Page 12

⁹ Keith Emmer's Emails, Tom & Lenell Chace to Keith Emmer, March 31, 2009, Page 52

¹⁰ Special Litigation Committee interviews, Plaintiffs, Page 1, Line 45

II. Demographics

There are 460.5 lots (voting units) in the HCEII development.¹¹ A voting unit is a lot. An equal annual assessment is assigned to each voting unit. 39% percent of the units have houses. 61% of the units are not developed.

Percent of Units according to level of Road Maintenance and Land Use

11%	Houses on Rose Canyon Rd (Maintained by SLCo)
4%	Unbuilt Lots on Rose Canyon Rd (Maintained by SLCo)
28%	Houses on Roads Maintained by HCEII
41%	Unbuilt Lots on Roads Maintained by HCEII
0%	Houses on Roads not maintained
16%	Unbuilt Lots on Roads not maintained

Percentage of Units with Greenbelt Status

30%	On Greenbelt Qualified by Bob Chew's Horses ¹²
23%	On Greenbelt Qualified by other
47%	Not on Greenbelt

Unpaid Assessments as of January 2010. (133.5 units or 33% owe HCEII assessments)

69 Units are on Rose Canyon Road (Maintained by SLCo)

- 15 units out of 69 units owe a total of \$7,251 in assessments
- 24% of resident units were past due on assessments
- 15% of nonresident units were past due on assessments

319.5 Units are on roads maintained by HCEII

- 89.5 units out of 319.5 units owe a total of \$62,326
- 19% of resident units were past due on assessments
- 34% of nonresident units were past due on assessments

72 Units are on roads not maintained

- 29 units out of 72 owe a total of \$63,300,
- There are no residents
- 40% of nonresident units were past due on assessments

¹¹ The smallest unit is 2.5 acres. The largest unit is a five to 9.9 acre portion of a larger lot.

¹² Documentation for the ACC, Letter from Tom Chace to the ACC, January 7, 2009; Bob Chew is the man used by the Property Rights/ Greenbelt Committee to qualify their members for greenbelt with his horses. Page 34

III. Favoritism

Claim: The Board has adopted an informal, non-written policy favoring resident lot owners over those who have not yet developed their properties. The Association adopted this policy even though assessments are based on lot size, not improvements. The Board has imposed a de facto residency requirement for members before they can serve on the governing boards of the Association.

- A. In the interview with the SLC Lindsay Atwood stated "And if we are paying the same dues as someone with a home we should get the same services"¹³. Lindsay Atwood is actually paying less in assessments than other members with similar lot sizes. Lindsay Atwood's property is located on Step Mountain.¹⁴ Geologically this is a 36-million-year-old volcano.¹⁵ In 1993 Lot 99, 27.92 acres, was assessed for five units and Lot 98, 23.17 acres, was assessed for four units.¹⁶ In 2007 Lot 99 was assessed for two units and Lot 98 was assessed for two units.¹⁷ This likely happened in 1993 as the result of Directors' Proposition 1992-C.¹⁸ No documentation has been found showing Salt Lake County Planning and Zoning determination of the number of buildable lots or that Board approval was obtained for the removal of assessments per the requirements outlined in the proposition 1992-C.¹⁹
- B. Brandon Frank owns Lot 102 on an unmaintained portion of Step Mountain Road and he owns or represents Lots 112 and 122C on a regularly maintained portion of Step Mountain Road.^{20 21} (Tom Chace's records show that he represents lot 122C under the name of Ryan Frank that has been qualified for greenbelt by Bob Chew.²²) As of April 2010, Mr. Frank owed \$1,270 in back assessments on lot 112 and \$635 on Lot 122C. He paid \$1,372 for back assessments owed on Lot 102 on December 2, 2009 after the complaint was filed on November 25, 2009.²³ Mr. Frank benefits from a longer distance of maintained roads to his lots 112 and 122C than any of the defendants and he has not paid assessments on those lots.²⁴
- C. Between 1994 and 2009 the Area D roads which access the plaintiffs' lots have received 47.92% of the maintenance funds spent by HCEII and they convey 26.69% of the traffic on

¹³ Special Litigation Committee Interviews, Plaintiffs, April 28, 2010, Page 13, Line 618

¹⁴ Section XII this report, Photograph #2

¹⁵ Various Documents HCEII, The Canyon Breeze, February 2010, *Fascinating Geologic Features Surround Rose Canyon*, Pat Henrie, Page 105

¹⁶ Various Documents HCEII, Hi-Country Estates Homeowners Association, Phase II Membership list as of 5/21/93, Randy Anderson, Lot 98, Units 4, Page 29, Earl Dillman Lot 99, Units 5, Page 30

¹⁷ Various Documents HCEII, Hi Country Estates Phase II, Home/lot owners as of June 2, 2007. Lindsay Atwood Lot 98 - Units 2, Lot 99 - Units 2, Page 72.

¹⁸ Various Documents HCEII, Directors Proposition 1992-C, "The primary justification for a change in assessable units would be based on the maximum numbers of parcels with buildable home sites, as determined by the Salt Lake County Planning and Zoning Commission" Page 27

¹⁹ Special Litigation Committee interviews, Walt Hoffman, the owners previous to him never requested the assessment change, it was just changed. Page 36, Line 1636

²⁰ Map, Status of HCEII Roads, Plaintiffs' Property

²¹ Section XII of this report, Photograph #9

²² Documentation For the ACC, Attachment to letter from Greenbelt Committee to ACC, January 7, 2009, Page 35

²³ Hi Country Estates Financial Records

²⁴ Map, Status of HCEII Roads

HCEII maintained roads. In comparison, Mountain Top Road and roads feeding into it received 29.31% of the maintenance funds and Mountain Top Road conveyed 22.43% of the traffic on HCEII roads. Rose Creek Road received 4.49% of the maintenance funds and it conveyed 16.74% of the traffic on HCEII maintained roads and 14900 South received 6.21% of the maintenance funds and it conveyed 12.68% of the traffic on HCEII maintained roads.²⁵

- D. Lindsay Atwood stated that he has requested financial documentation and records many times and has not gained access to accounting records of the HOA^{26 27}. The Bylaws state that "the books, records, ledgers and papers of the Association shall... be subject to inspection by any member"²⁸

SLC Recommendation #1: Only one place could be found in the association records where Lindsay Atwood asked about financial records and that was for an analysis. The Board does not need to provide any analysis but the financial records are to be available to the membership per the Bylaws. In order to clear up any communication problems, the SLC recommends that Mr. Emmer contact Mr. Atwood and suggest that he set a time with the Association Treasurer to review the records so that he can find the information that he needs.

SLC Recommendation #2: The Association has information including unlisted phone numbers and addresses, members who owe the association money, bank account numbers, who is paying bills on behalf of another and other information that may be considered confidential. The Board has made a judgment that some of this information is confidential. It is recommended that they seek legal counsel regarding what is confidential and request advice as to the procedures for distributing this information when it is requested.

1. Lindsay Atwood requested that the Association supply him an income statement broken down by landowners VS homeowners.²⁹ Keith Emmer never did this analysis.
2. Tom and Lenell Chace asked Keith Emmer for a list of people who owed HCEII money and how much.^{30 31 32} Mr. Emmer responded to the Chaces' requests with the statement "Out of privacy concerns we will not give specifics as to who owes what to the association. We have a yearly audit and that you can examine. That tells how much assessments are owed."³³ Tom Chace made another request for unpaid assessments and stated that he did not think the information was sensitive or confidential.³⁴

²⁵ Various Documents HCEII, HCEII Road Maintenance Patterns 1994 to 2009. Spread Sheet, Page 104

²⁶ Special Litigation Committee Interviews, Plaintiffs, April 28, 2010, Page 16, Line 718

²⁷ Special Litigation Committee Interviews, Plaintiffs, April 28, 2010, Jerry Gilmore cited Tom and Lenell Chace's requests for records as proof, Page 16, Line 730

²⁸ HCEII Bylaws, Article XI: Books and Records

²⁹ Various Documents HCEII, Monthly Meeting Minutes September 29, 2008

³⁰ Keith Emmer's Emails, Keith Emmer to Tom & Lenell Chace, December 19, 2008, Page 43

³¹ Keith Emmer's emails, Tom & Lenell Chace to Keith Emmer, January 8, 2009, Page 46

³² Keith Emmer's Emails, Tom & Lenell Chace to Keith Emmer, March 4, 2009, Page 48

³³ Keith Emmer's emails, Keith Emmer to Tom & Lenell Chace, March 4, 2009, Page 49 & 50

³⁴ Keith Emmer's Emails, Tom Chace to Keith Emmer, April 25, 2009, Page 76

3. On May 11, 2010 Tom Chace sent an email asking for access to records. Keith Emmer referred him to the HCEII Treasurer.³⁵ This is the only request outside of items 1 and 2 above that could be found.

E. Tom Chace has presented himself as the lead for both the Property Rights and the Greenbelt Committees³⁶ At the September 29, 2008 monthly meeting, he requested that HCEII fund the following three items and the Board responded in writing on October 5, 2008:^{37 38}

1. Provide \$20,000 for a property survey to find lot corners. The Property Rights Committee felt that the Board owed them this survey because they (the owners of undeveloped land) have funded roads for other property owners over the years. The board responded that there are not funds in the 2008-2009 budget to do the survey.
2. Fund five fire hydrant water meters so that greenbelt properties that do not have a water connection but need hoses to qualify for greenbelt can get water. The Board responded that they would allow two meters for a \$5,000 deposit. The deposit would insure against damage to the fire hydrant as well as insure payment for the water at the same rate charged to residential users.
3. Provide \$20,000 to hire a consultant to look at the feasibility of incorporating into a city. The Board responded that the Association did not have \$20,000 to fund a study to incorporate and it is an individual property owners concern to consider incorporation, not the Board's.

F. On October 16, 2008, Tom Chace sent out an email "Hi Country Greenbelt Letter" to a group of landowners. He stated "Residents of Hi Country get a newsletter in their water bill. Those of us who are non- residents remain uninformed and it is up to each of us to pay attention if we ever hope to build on or sell our property. ... To access the Board minutes you need to register. This means someone can track who goes into different areas on the Hi Country web site. Therefore, if you want to use the group registration we have set up... when you log in screen, the User Name is- Kilroy was here...."³⁹

G. The plaintiffs believe that there is de facto residency requirement to be on the board.

SLC Observation #1: The Plaintiffs did not show that there is or has been a de facto residency requirement to be on the Board.

1. The majority of past Board members and officers have been residents of HCEII however there have been individuals that were not residents at the time they were on the Board or the ACC. Some of them include Terry Shobe, Joe Chivala, Ray Meyers, Marty Philips, Warren Cole, Dale Jones, Eldon Howard, Kim Wilson, Lionel Brown, Ray Meyers, Gus Colovos, Larry Fuller and Ken Johnson.⁴⁰

³⁵ Various Documents HCEII, Tom Chace to Keith Emmer, May 11, 2010, Page 144

³⁶ Keith Emmer's Emails: Tom & Lenell Chace to Keith Emmer, Tue, 31, Mar 2009, Page 52

³⁷ Various Documents HCEII, Monthly Meeting Minutes, September 29 2008, Page 76

³⁸ Keith Emmer's Emails, To Tom & Lenell Chace from Keith Emmer October 8, 2008, Page 18

³⁹ Keith Emmer's emails, Tom and Lenell Chace to some Greenbelt Property Owners. October 16, 2008

⁴⁰ Review of past annual meeting minutes and correspondence by Arlene Johnson

2. Scott Royal, nonresident, was nominated for a Board position by the plaintiffs at the 2007 Annual meeting.⁴¹ ⁴² He was not elected and did not attempt to run for the Board again. Mike Huber, a nonresident, was also nominated at the 2007 annual meeting.⁴³ He was not elected.
3. Tom and Lenell Chace were asked in advance of the 2009 Annual Meeting if they wanted to put any names on the ballot so it could be mailed out before the annual meeting.⁴⁴ Tom Chace, representing the Property Rights/ Greenbelt Committee, wanted to know how many board positions were open.⁴⁵ Keith Emmer responded that the roads position and the water position were open. He emphasized the time commitment of both positions.⁴⁶ The Property Rights/ Greenbelt Committee did not identify anyone to run for the Board in 2009⁴⁷ but they did nominate Jeff Ohlson as a candidate for the ACC.⁴⁸ ⁴⁹ Jeff Ohlson is a resident and he owns greenbelt property qualified under Bob Chew.⁵⁰ He was elected in June 2009 to replace Annette Emmer, a resident.
4. Plaintiffs were asked by the Special Litigation Committee if they knew of any nonresident who was told they could not run for the board.⁵¹ They produced an email Keith Emmer sent to Tom Chace on April 21, 2009 outlining the time commitment and the responsibilities of the positions up for election. This email does not mention residency.⁵² The plaintiffs did not produce any other communication or relevant information.
5. The plaintiffs mentioned that there was a requirement that if a committee member misses one emergency meeting they will be taken off the committee.⁵³ No evidence of this alleged requirement has been found. The Bylaws state that the Board can declare the office of a Director to be vacant in the event such Director shall be absent from three consecutive regular meetings of the Board.⁵⁴
6. At every annual meeting members are solicited to serve on the ACC, the Board, area coordinators, treasurer and secretary. None of the three plaintiffs, Tom Chace or Lenell Chace have ever volunteered to run for office.

⁴¹ Special Litigation Committee Interviews, Plaintiffs, April 28, 2010, Brandon Frank Page 14 Line 643

⁴² Various Documents HCEII, Annual Meeting Minutes, June 7, 2007, Page 69, Paragraph 4

⁴³ Various Documents HCEII, Annual Meeting Minutes, June 7, 2007, Page 69, Paragraph 4

⁴⁴ Keith Emmer's Emails, Keith Emmer to Tom and Lenell Chace, Monday April 20, 2009. Page 65

⁴⁵ Keith Emmer's Emails, Tom and Lenell Chace to Keith Emmer, Tue, 21 Apr 2009, bottom of Page 68

⁴⁶ Keith Emmer's Emails, Keith Emmer to Tom and Lenell Chace, Tuesday April 21, 2009, Page 68

⁴⁷ Keith Emmer's Emails, Tom and Lenell Chace, Tuesday, April 21, 2009. "We have no names to add to the ballot.", Page 69

⁴⁸ Special Litigation Committee Interviews, Plaintiffs, April 28, 2010, Brandon Frank Page 14 Line 653

⁴⁹ Keith Emmer's Emails, Tom & Lenell Chace to Keith Emmer, Fri, 24 Apr 2009 stating "We would like to add Jeff Ohlson's name as a candidate for the ACC", Page 74

⁵⁰ Documentation for Architectural Control Committee, Letter dated January 7, 2009 from the Greenbelt Committee to the ACC. attachment includes everyone qualified by Bob Chew's horses from Greenbelt

⁵¹ Special Litigation Committee Interviews, Plaintiffs, April 28, 2010, Page 14, Line 663

⁵² Keith Emmer's Emails, Keith Emmer to Tom Chace, April 21, 2009, Page 68

⁵³ Special Litigation Committee Interviews, Plaintiffs, April 28, 2010, Page 15, Line 694

⁵⁴ Bylaws of HCEII Article VII, Section 1 -d

IV. Roads

Claims: The Board has denied some members access to their property on safe or maintained roads. The Board has failed to maintain roads in a safe and reasonable uniform manner and condition. The Board is engaged in self dealing in that roads near Board members homes are maintained and improved.

- A. HCEII was never a properly platted and recorded subdivision. The "roads" are defined as 50 foot right-of-way easements for access to parcels of land in Hi Country Estates Phase II.⁵⁵ These right-of-ways are recorded as meets and bounds legal descriptions of centerlines with 25 feet on each side. These "roads" were never designed for traffic flow, grade changes, fire truck access or storm water runoff controls as normally required by a governing agency for residential access roads. Salt Lake County has never approved the roads in HCEII as a group of residential roads. Once Salt Lake County approves a building permit it has been assumed by HCEII that improvements to the easement are adequate to treat it as a road and regular maintenance begins.
- B. There are three types of roads in Hi Country Estates Phase II. Each is maintained in a different manner.
 1. Properties owned by both residents and nonresidents located on the paved Rose Canyon Road receive road maintenance from Salt Lake County. This is a public road with the right-of-way dedicated to Salt Lake County.⁵⁶ Salt Lake County uses property taxes paid by all owners of taxable real estate in the unincorporated areas of Salt Lake County to pay to maintain Rose Canyon Road. 15% or 69 out of 460.5 units front on Rose Canyon Road. They do not need to access any HCEII private roads in order to travel in and out of HCEII or to access their property. They pay the same assessments as the rest of HCEII.⁵⁷
 2. Properties owned by both residents and nonresidents located on private roads receive maintenance from HCEII. This is about 69% or 319.5 out of 460.5 units. All of the defendants in the lawsuit (with the exception of Carol Dean who has since resigned and moved out of state) are residents of HCEII and the roads fronting their properties were maintained by HCEII before they were on the board.⁵⁸ The cost of maintenance of roads maintained by HCEII is covered by assessments shared by all members of the homeowners association. Tom and Lenell Chace's 40 acres front these roads. Brandon Frank has two lots fronting these roads.
 3. Properties owned by only nonresidents front rough graded right-of-way easements that are not regularly maintained by HCEII. They receive minimal maintenance, they do not lead to any residences and there is minimal traffic. This includes about 16% or 72 out of 460.5

⁵⁵ Various Documents HCEII, Special Warranty Deed, Zion's First National Bank to James and Frieda Mascaro, March 20, 1974, Page 122

⁵⁶ Various Documents HCEII, Salt Lake County VS HCEII, December 20, 1986, Page 129

⁵⁷ Special Litigation Committee Interviews, Richard and Dorothy Mittlestaedt, They live on Rose Canyon which is maintained by Salt Lake County and expressed disagreement with using their assessments to pay for everyone else's improvements. Page 42, line 1882

⁵⁸ Map, Status of HCEII Roads, Defendant's Property

units. All three plaintiffs own property on these easements that are not regularly maintained by HCEII⁵⁹. They travel on about 1 3/4 miles of HCEII maintained roads to get to the area where maintenance ends. They must travel about 3/4 miles of rough graded easements to access their lots.

- C. The HCEII Certificate of Incorporation states: *"The Association is also formed to promote the health, safety and welfare of the residents within Hi Country Estates II....."*⁶⁰

SLC Observation #2: Past boards and the current board have treated annual road maintenance, improvements and snow removal as health, safety and welfare responsibilities to the residents within Hi Country Estates II. Historically, maintenance does not begin on a road until the County issues a building permit for a residence on that road.

1. In the early to mid 1980s, Mascaro Trucking was hired to grade and remove snow from the entrance of Hi- Country Estates II to existing residents; Lot 44 (Andreason) on Rose Canyon Road⁶¹, Lot 18 and 23 (Larry Fuller and Harvey Heed) on Mountain Top Road.⁶² In 1984⁶³ and 1986⁶⁴ the practice of grading and improving roads to existing homes and homes under construction was articulated by the Board.
2. The only road work done in "Area D" (Area D encompasses the roads from Rose Canyon Road to the plaintiffs' properties) between the times when the right-of-way easements were originally rough graded in the 1970s and when a pad (fire truck turnaround) was constructed for Jerry Gilmore in the early 1990s was for access to construction of the upper water tank, the upper well and related piping.^{65 66}
3. Larry Fuller, President of HCEII in 1992, articulated to Salt Lake County that the Association was committed to grade and improve Step Mountain Road between lot 100 and lot 106; however, he also stated that the timing for totally completing the work was based on Mr. Gilmore, the owner of lot 100, applying for a building permit.⁶⁷
4. Regular annual road maintenance in Area D from Rose Canyon Road to lot 92 began when the Step Mountain LLC development was started in the 1995.^{68 69}
5. There are no residences on the segment of Step Mountain Road between lots 76 and 92. After the water lines were installed in 1993, the segment of Step Mountain Road between lots 76 and 100 was treated as a utility right-of-way rather than a road because Salt Lake

⁵⁹ Map, Status of HCEII Roads, Plaintiff's Property

⁶⁰ Certificate of Incorporation, Hi-Country Estates Homeowners Association; Third Article

⁶¹ Various Documents HCEII, Salt Lake County VS HCEII, Salt Lake County did not claim ownership to Rose Canyon Road and start maintaining it until 1991, Page 130 section 4.

⁶² Special Litigation Committee Interviews, Rex Facer, Page 15, Line 668

⁶³ Various Documents HCEII, Letter to Members from Board, May 10, 1984, Page 1

⁶⁴ Various Documents HCEII, Fall 1986 Membership Status Letter, Capital Improvements and Maintenance, Page 4

⁶⁵ Special Litigation Committee Interviews, Rex Facer, Page 19, Line 860

⁶⁶ Various Documents HCEII, Monthly Meeting Minutes, August 27, 1991, Page 10

⁶⁷ Various Documents HCEII, Letter: Larry Fuller to Salt Lake County RE Subdivision Application PL 92-1077, By Jerry Gilmore, August 13, 1009, Page 115

⁶⁸ Special Litigation Committee Interviews, Rex Facer, Page 19, Line 843

⁶⁹ Various Documents HCEII, Letter from Step Mountain LLC to the Members in Area D. Feb. 8, 1996, Page 47

County would not approve the steep grade for residential access.⁷⁰ Other parts of this right-of-way also lead through a drainage subject to storm water runoff. This is the location of the plaintiffs' properties.^{71 72}

- D. Certificate of Incorporation, Article II, Subsection 2 states " *The homeowners Association is obligated to provide maintenance and all services stated above only to the extent that such maintenance and services can be provided with the proceeds of such annual payments*" About \$60,000 per year is spent to maintain 10.5 miles of roads. Residents complain about the condition of the gravel roads.
1. A visual inspection shows that the roads receive minimal maintenance in order to stay within this budget.⁷³ In the SLC interview, Robert Messmer complained about Shaggy Mountain Road where he lives⁷⁴
 2. Keith Emmer stated that road maintenance projects and needs are identified by the Board on an annual basis. They drive the HOA area and identify deteriorated areas on roads that lead to residences. They also respond to complaints regarding the condition of roads⁷⁵
- E. Step Mountain Road leading to the plaintiffs' properties was drivable in 1993. Walt Hoffman owned lot 99 between 1993 and 2006. Mr. Hoffman stated that in 1992 when he purchased his lot he could drive a two wheel drive vehicle up the steep section of Step Mountain Road (between lots 76 and 100)⁷⁶ Jerry Gilmore stated that he could drive a sedan to his lot 100 in 1992 when he purchased it.⁷⁷

SLC Observation #3: Upper Step Mountain Road was made passable in the early 1990s primarily for construction equipment to deliver supplies for the well and water tank and to install water lines.

1. On August 27, 1991 the Board authorized grading Arnold Hollow Road and Step Mountain Road in order to get pipe delivered for water transport from the well and so that a generator could be set up at the well house. The Board consisting of Larry Fuller, Ed Huish and Sydney Morganson voted on making a passable road.⁷⁸ In summer of 1992 the upper well and associated water lines were under construction. These lines were installed in Step Mountain Road.⁷⁹ Rough grading was necessary to complete the installation of water lines.
2. In 1993 Larry Fuller stated that Salt Lake County Planning and Zoning would not accept the use of Step Mountain Road and Arnold Hollow Roads as the primary access to the lots or

⁷⁰ Various documents HCEII, Directors Proposition 1992-D, Page 28

⁷¹ Map, Status of HCEII Roads, Plaintiffs' Property

⁷² Section XII of this document, Photograph #1

⁷³ Section XII of this document, Photographs 1-13

⁷⁴ Special Litigation Committee Interviews, Robert Messmer, resident, Page 50, Line 2266

⁷⁵ Special Litigation Committee Interviews, Keith Emmer, Page 11, Line 499

⁷⁶ Special Litigation Committee Interviews, Walt Hoffman, Page 34, Line 1513

⁷⁷ Special Litigation Committee Interviews, Plaintiffs, April 28, 2010, Page 6, Line 255

⁷⁸ Various Documents, Monthly Meeting Minutes, August 27, 1991, Page 10

⁷⁹ Various Documents HCEII, Annual Meeting Minutes, 1992, Page 13

homes on the southeast side of the HCEII. Step Mountain is too steep and Arnold Hollow Road is too long for public safety vehicle (police and fire) response.⁸⁰

- F. Past practices show that capital improvement projects are needed to bring some "roads" up to a standard that they can effectively be maintained by the Association and they meet Salt Lake County standards for access in order to issue a residential building permit.⁸¹ These projects have been funded with past assessments, lot foreclosures, developers and special assessments. The segment of Step Mountain Road between Lot 92 and 76 as well as other unmaintained easements in the development, are not included in this list because there has never been a capital improvement project to bring these roads to Salt Lake County standards. In December of 2008 Keith Emmer suggested to Tom Chace, representing the Greenbelt/Property Rights Committee, to determine from the County what the roads require to meet standards.⁸² There was no response to that request.⁸³
1. At the time building permits were granted, there were roads within HCE II that met Salt Lake County standards for granting a building permit without substantial improvements after the original road was cut in 1974.
 - a. Shaggy Mountain Road Lot 18 to 7
 - b. Country View Lane
 - c. Rose Creek Lane, lower section
 - d. Mountain Top Road
 - e. Sharose Road
 - f. Lower Step Mountain Road
 2. Capital Improvement projects were completed by developers on roads that needed to be improved to meet Salt Lake County standards for a building permit. These roads have been maintained by HCEII from the time they were completed. They include the following:⁸⁴
 - a. Step Mountain LLC - East part of Area D⁸⁵
 - b. Wapiti Heights - West part of Area D
 - c. Mascaro Estates - All Roads that feed into 14900 South and 14900 South to Rose Canyon Road⁸⁶
 3. In 1993 a special assessment was approved for some roads.⁸⁷
 - a. Step Side Road (Salt Lake County never granted approval)
 - b. Shaggy Mountain Road Lots 1 to 7
 - c. Shaggy Mountain Road Lots 1 to 162
 - d. Rose Creek Lane, Upper ¼ mile
 - e. Arnold Hollow Road Lot 77 to 170

⁸⁰ Various documents HCEII, Directors Proposition 1992-D, Page 28

⁸¹ Various Documents HCEII, Letter from Step Mountain LLC to Area D Lot Owners, Feb 8, 1996, Page 47

⁸² Keith Emmer's Emails, Keith Emmer to Tom Chace, Monday, December 15, 2008 paragraph 6, Page 40

⁸³ Special Litigation Committee Interviews, Keith Emmer, Page 3, Line 117

⁸⁴ Special Litigation Committee Interviews, Keith Emmer, Page 12, Line 533

⁸⁵ Various Documents HCEII, Letter from Step Mountain LLC to Area D members summarizing the project. Feb. 8, 1996. Page 47

⁸⁶ Special Litigation Committee interviews, Rex Facer, Page 20, Line 920

⁸⁷ Various Documents HCEII, Director's Proposition 1992-D, Page 28

- G. Jerry Gilmore stated that the owners of lots along upper Step Mountain Road (from Lot 92 to lot 100) should not have to pay a special assessment for capital improvements per Certificate of Incorporation because HCEII had made a commitment to complete the capital improvements that would upgrade Step Mountain Road leading to his lot 100.⁸⁸

SLC Observation #4: Because Mr. Gilmore closed on the property he purchased from HCEII before his subdivision was recorded, he purchased Lot 100 as is and the Association had no contractual obligation to Mr. Gilmore. Even though he knew he could not get a building permit because Salt Lake County Health Department would not approve a septic tank, Mr. Gilmore continued to request that the Association grade his road with the justification that he needed it graded to get a building permit.

1. Jerry Gilmore purchased his lot 100 from HCEII. He signed an earnest money agreement in April 1992 and closed on property in October 1992. He agreed that the buyer will obtain subdivision approval from Salt Lake County Planning and Zoning. If the county will not qualify property for building this earnest money agreement is cancelled.⁸⁹
2. Before Mr. Gilmore closed on his lot, Larry Fuller, (President of the Association) sent a letter to Salt Lake County stating that the Homeowners Association would upgrade Step Mountain Road by recrowning it, placing culverts at appropriate grade points, from Lot 100 and to Lot 106 to allow surface water to run from the east side of the natural drainage to the west. The timing for totally completing the work was based on Mr. Gilmore applying for a building permit. Mr. Fuller asked that the County approve the Gilmore subdivision with the stipulation that a building permit not be granted without the roadway upgrading by the association and approved by the County.⁹⁰ The SLC was not able to find any such written stipulation by Salt Lake County. There is also no documentation addressing Salt Lake County's position on the condition of the segment of road from lot 106 to Arnold Hollow Road.
3. The Gilmores closed on their lot in October 1992. In the June 1993 Annual Meeting a proposition was presented by Larry Fuller requesting approval for a special assessment for various roads in the association and an extension of Step Side Lane. (The extension of Step Side Road was never approved by the County but use of Arnold Hollow Road for ingress/egress was eventually approved.) Improvements to the section of Step Mountain Road that fronts the plaintiffs' properties and improvements to roads between Arnold Hollow Road and lot 106 were not included in this proposition.⁹¹
4. In the Special Litigation Committee Interview Mr. Gilmore stated: *"The subdivision was recorded, everything was approved with exception of the roads and Salt Lake County was waiting for High Country Estates to fulfill their commitments to make the roads and that was the only thing that was holding them back."*⁹² He also stated *"The subdivision was never completed because High Country Estates didn't complete their agreement."*⁹³ Salt

⁸⁸ Special Litigation Committee Interviews, Plaintiffs, April 28, 2010, Page 11. Line 484

⁸⁹ Various Documents HCEII, Earnest Money Sales Agreement dated April 14, 1992, Considerations and Contingencies. Page 12

⁹⁰ Various Documents HCEII, Letter: Larry Fuller to Salt Lake County RE Subdivision Application PL 92-1077, By Jerry Gilmore, August 13, 1009, Page 115

⁹¹ Various Documents HCEII, Proposition 1992-D, Page 28

⁹² Special Litigation Committee Interviews, Plaintiffs, April 28, 2010, Page 11, Line 512

⁹³ Special Litigation Committee Interviews, Plaintiffs, April 28, 2010, Page 11, Line 518

Lake County Development Services has no record of stipulations for approval or that Mr. Gilmore recorded his subdivision thus he could not have applied for a building permit.⁹⁴

5. Mr. Atwood also stated that a subdivision was recorded for his lot 98.⁹⁵
6. Step Mountain Road from Step View Drive to Step Side Road was funded between 1995 and 1996 by Step Mountain LLC and other members whose property fronted on this road. Improvements installed by Step Mountain LLC and other association members were originally planned to extend along High Step Lane to Jerry Gilmore's lot 100⁹⁶. These planned improvements would also have extended to Lindsay Atwood's lot 98.
7. February 4, 1995, 2.5 years after closing on his lot, Mr. Gilmore wrote a letter to the Board of Directors stating that then Association president, Larry Fuller, made a verbal agreement that if (Gilmore) purchased this property, HCEII would provide Salt Lake County Planning and Zoning approved Ingress and Egress.⁹⁷ This was also discussed in the 2009 Annual Meeting and there were conflicting memories of previous commitments.⁹⁸ In the meeting with the Special Litigation Committee Mr. Gilmore stated: *"Actually whenever I bought my property the Homeowners Association agreed to bring all roads to my property up to county code so that I can get a building permit for that."*⁹⁹
8. The February 4, 1995 letter from Mr. Gilmore also requested that the fire truck turn-around be built. The Board seemed to think it had been completed.^{100 101} In the interview with the Special Litigation Committee Mr. Gilmore stated *"... I agreed to a fire truck turnaround on my property and the association actually came in there and they put road base down for the turn and they started going back up that road and then it came to a stop. The Board put a stop to it. So it was, the Homeowners Association actually paid for the road base that was on the turnaround on my property."*¹⁰²
9. Fifteen years ago, the Board determined that the Association had no obligation to Mr. Gilmore for building a road based on a July 20, 1995 opinion by Daniel Gibbons, the association's legal counsel, regarding Gilmore's Earnest Money Agreement. It was stated that the language in the Earnest Money Agreement was unenforceable after closing since the only result of nonperformance is cancellation of the Earnest Money Agreement. The performance must occur, if at all, while the Earnest Money Agreement is still pending.¹⁰³

⁹⁴ Salt Lake County Development Services, File on Jerry Gilmore's subdivision PL-92-1077, renumbered as 5853

⁹⁵ Special Litigation Committee Interviews, Plaintiffs, April 28, 2010, Page 11, Line 493

⁹⁶ Various Documents HCEII, Letter to Board of Directors from Area D property owners. June 23, 1995, Map, Page 41

⁹⁷ Various Documents HCEII, Letter from Jerry and Catherine Gilmore to HCEII. February 4, 1995, Page 32

⁹⁸ Recording of 2010 Annual Meeting

⁹⁹ Special Litigation Committee Interviews, Plaintiffs April 28, 2010, Page 11, Line 484

¹⁰⁰ Various Documents HCEII, Letter from Jerry Gilmore to HCEII, February 4, 1995. "Lack of progress on the fire truck turnaround" Handwritten note on Mr. Gilmore's letter stating that this was complete. Page 31

¹⁰¹ Special Litigation Committee Interviews, Rex Facer Page 19, Line 860 and 874

¹⁰² Special Litigation Committee Interviews, Plaintiffs, April 28, 2010, Page 10, Line 435

¹⁰³ Various Documents HCEII, Opinion on Gilmore Earnest Money Agreement, Daniel Bay Gibbons, July 20, 1995. Page 33

10. Salt Lake County's adoption of the Foothills and Canyons Overlay Zone (FCOZ) in 1998 created development limitations and increased the costs of development in HCEII.¹⁰⁴ The Property Rights Committee considers this "the cruelest form of imminent domain".^{105 106} Even if they have a recorded subdivision, before obtaining a building permit each of the plaintiffs will need to comply with FCOZ.¹⁰⁷ Because the slope of their lots exceeds 30% and parts of the plaintiffs' lots are on the ridgeline, Chapter 19.72.030 Section B, 3 & 4 of FCOZ may cause the plaintiffs' lots to be undevelopable.^{108 109} (This determination can only be made by the Salt Lake County Development Services Division)
11. In 2001 a drinking water source protection plan for Herriman City's spring along Arnold Hollow Road was completed and filed with the State. This led to a septic tank moratorium for the parts of Area D that drain into this spring. Because there is no sewer and septic systems are the only source of waste water treatment in that area, development was effectively halted in most of Area D as a direct consequence of Herriman's water source protection plan and the Salt Lake County Health Department's unwillingness to consider alternative septic (i.e. closed) systems. The plaintiffs' properties are not in this moratorium in that they drain along Step Mountain Road to the north.
12. Mr. Gilmore stated at the January 31, 2006 monthly meeting that the road and subdivision had been approved but he has not been through FCOZ. He said that he could not get a building permit until the road is improved. Mr. Gilmore was advised to work with the Board and go through the County to make sure he could build on his lot.^{110 111} Jerry Gilmore appeared at several other meetings of the Board requesting that his road be graded.^{112 113 114} The section of Step Mountain Road fronting Jerry Gilmore's property also serves the other plaintiffs' properties and the HCEII well house. It runs along a gully through deep clay and becomes rutted when it is wet and driven on.¹¹⁵ The "road" has never been engineered and

¹⁰⁴ C-2 Chapter 19.72 FOOTHILLS AND CANYONS OVERLAY ZONE (FCOZ) Salt Lake County Government Web Site <http://WWW.co.sl.c.ut.us/>)

¹⁰⁵ Keith Emmer's Emails, Hi Country Property Owners, Lindsay Atwood, Dave Moore and Tom Chace, August 18, 2008, Page 9, #2, last sentence

¹⁰⁶ Various Documents HCEII, Letter from the Property Rights Committee to HCEII members, May 6, 2010, Page 139.

¹⁰⁷ Various Documents HCEII, Cal Schneller, Salt Lake County Planning Director 1996-2002, Page 114

¹⁰⁸ Various Documents HCEII, Unbuildable Area>30%, Page 136

¹⁰⁹ Map, HCEII Non-Buildable Land Area, Hansen Allen & Luce Engineers

¹¹⁰ Various Documents HCEII, HCEII, Agenda for January 31, 2006 monthly meeting with handwritten note by Arlene Johnson, Page 60

¹¹¹ Various Documents HCEII, Cal Schneller, Salt Lake County Foothill Overlay Zone, The FCOZ zone came into effect in December 1997. If the subdivision had been recorded before that date it would have been a legal nonconforming lot and exempt from the FCOZ provisions but obtaining a building permit from a structure would require compliance with FCOZ. Page 114, Item 6

¹¹² Various Documents HCEII, Minutes from the July 5, 2006 Directors' meeting. Mr. Gilmore stated that his road had been neglected for thirteen years. He has decided not to build on his property and is trying to sell it. Page 65

¹¹³ Various Documents HCEII, Annual Meeting Minutes, June 9, 2007, Jerry Gilmore stated that he had his land since 1992 and his road had never been graded. He cannot get to his property and cannot build because the County says he needs a better road. The Board of Directors stated that the Board provided the most money where the most people live. Page 68

¹¹⁴ 2009 Annual Meeting, Recording

¹¹⁵ Section XII this report, Photograph #7

lacks culvert pipes and road base installed to divert storm water. Upper Step Mountain Road was graded and Tony Mascaro filled in a washed out area along the water line in the fall of 2006^{116 117}, it was graded to the well house the spring of 2008.^{118 119} and in November 2009 it was graded for access to the well house.¹²⁰

13. Mr. Gilmore stated that he met with Salt Lake County Health Department Director about four years ago (2006) and he was told that they would not approve a septic tank on his property.¹²¹ If he could not get a septic tank approved, he could not get a building permit.
14. At various annual meetings, some form of a proposition to create a special assessment for improvements to roads has been presented by the Board. Every proposal has been voted down since 1993. The recent vote in 2009 showed that all of the plaintiffs voted against paying additional funds in addition to annual assessments for roads.¹²²
- H. The June 12, 2009 Demand letter from Wade Budge, Plaintiffs' Attorney, states that the Board has failed to act in accordance with its fiduciary duties in that the Board does not maintain the roads within the Association in an equal or nondiscriminatory manner. All members of HCE II pay the same assessments and they receive a different level of road maintenance.

SLC Observation #5: Some property owners do not have maintained roads that front their property. However this is not due to neglect of fiduciary duties of the Board in that the governing documents were complied with, and were consistent with past practices. The Board's method of prioritizing road maintenance and improvement is consistent with state and local government practice. Furthermore, the Board must operate within the funds actually available.

SLC Observation #6: The Board's legal counsel's opinion differs from Wade Budge's opinion. Where an issue results in a conflicting interpretation of the law between Attorneys, the Board's most responsible option is to act according to the opinion of their legal counsel.

1. The Certificate of Incorporation, Addendum Part II allows the Homeowners Association the power and purpose to install utility improvements within an area designated by the association. Utilities have been interpreted to include water and road improvements.¹²³
2. The Special Litigation Committee compared traffic patterns with money spent on road maintenance. Records from the past fifteen years show that segments of roads with the highest traffic volume receive the greatest level of maintenance and efforts have been made

¹¹⁶ Various Documents HCEII, Board Meeting Minutes, July 5, 2006, The Board decided to get a cost estimate. Page 65. The road was graded and a washed out area filled in fall of 2006. Tony Mascaro was paid for this work.

¹¹⁷ Section XII of this document, Photograph #4

¹¹⁸ Annual Meeting Recording, June 2008, a statement was made by the Board that the road to the upper well had been graded.

¹¹⁹ Special Litigation Committee Interviews, Rex Facer, Page 17 Line 773

¹²⁰ Section XII this report, Photograph #8

¹²¹ Special Litigation Committee Interviews, Plaintiffs, April 28, 2010, Page 17, Line 788 & 802

¹²² Various Documents HCEII, 2009 Proposition Voting Results, Page 83

¹²³ Various Documents HCE II, Opinion on June 23, 1995 Proposal from Area "D" Owners, Dan Gibbons, July 10, 1995, Roads were treated as utilities per Certificate of Incorporation, Page 42

to construct them to the most durable standard.¹²⁴ The Board spends funds to remedy the wear and tear on the roads created by traffic volume. This is consistent with practices of the State of Utah and local governments. If equal money were spent on all roads, the collectors most used would fall into disrepair while the roads seldom used would remain in the best condition.

3. In the November 24, 2008 annual meeting Jerry Gilmore suggested that the *"roads should all be equal and that nicer roads should be allowed to degrade if needed so that the other roads reach better condition."*¹²⁵
4. In an email to Tom Chace dated December 15, 2008, Keith Emmer stated *"We maintain roads that receive the most vehicle traffic because vehicle traffic causes a high amount of wear, wash boarding, uneven compaction and redistribution of road base. In that the Association funds are not adequate to even repair this ongoing damage, we cannot be expected to repair low traffic areas that have not been engineered to prevent water runoff damage."*¹²⁶
5. In a letter, dated February 27, 2009, from Mike and Laurel Bruun, nonresident members, they quoted Greg Schmidt, attorney and nonresident member, *"...HCEII. Has violated its obligations in how they have used the assessments they have collected historically. If they did not have enough money to maintain all of the roads to a high standard, then they should have maintained all of the roads to a lesser standard, not some of the roads to a high standard with some of the roads receiving no maintenance. ...the Board of Directors of a HOA owes a fiduciary obligation to all members of the association not to provide services in a discriminatory fashion...."*¹²⁷
6. In a discussion of the Addendum to the Certificate of Incorporation, Daniel Gibbons, previous legal counsel to the Board, pointed out that the association "shall have the right" to install utilities or roads. Nowhere is the Association bound by a 50% vote to install roads, the directors are limited in debt and bound to stay within a budget.¹²⁸
7. This question of not giving all roads in HCEII an equal level of maintenance was addressed with Howard Lundgren, the association's attorney, after receipt of the June 12, 2009 Demand letter. Howard Lundgren's verbal advice to the Board was that the Board was within its rights to manage the road maintenance projects according to a consistent business plan.¹²⁹

¹²⁴ Various Documents HCEII, Hi Country Estates II Road Maintenance Patterns 1994 to 2009, December 2009, Page 99

¹²⁵ Various Documents, HCEII, Monthly Meeting Minutes November 24, 2008, Page 117

¹²⁶ Keith Emmer's Emails, Keith Emmer to Tom and Lenell Chace, December 15, 2008, Page 39

¹²⁷ Various Documents HCEII, Letter from Mike and Laurel Bruun to HCEII, February 27, 2009, Page 80

¹²⁸ Various Documents HCEII, Opinion on June 23, 1995 Proposal from Area "D" owners. Daniel Gibbons, Page 42

¹²⁹ Arlene Johnson's and Tony Sarra's recollection of the discussion with Howard Lundgren.

- I. When Mr. Atwood and Mr. Frank purchased their lots they were aware of the road conditions. They have not changed since that time.

1. Mr. Atwood commented that he had to walk ½ mile to get to his property when he first looked at it before purchasing it.¹³⁰ In the Special Litigation Committee Interviews Mr. Atwood stated: "... in my first HOA meeting that I went to I explained that the roads were a disaster, that we're paying associations dues, I was told by the Board the intent of the Board was they would work on the roads the following year. That was four years ago they were going to start working on the roads."¹³¹ The Board stated at the 2005 Annual meeting that they would grade Step Mountain Road.¹³² It was graded from lot 106 to lot 100 in the fall of 2006.¹³³
2. In the September 2006 monthly meeting Mr. Atwood wanted to know when the road up to his area was going to be repaired because he was having difficulty getting to the property he recently purchased. Keith Emmer told him that High Step Lane was in fairly good shape and the steep section of Step Mountain Road could not be repaired.¹³⁴
3. Brandon Frank purchased his lot in January 2006. He stated that he had a difficult time accessing it when he purchased it.¹³⁵
4. Sometime between 6/08 and 6/09 Mr. Atwood purchased another lot, 64A, with slope and access limitations.¹³⁶
5. All three Plaintiffs' properties are located within an area termed "Area D". They must travel on HCEII maintained roads (Arnold Hollow Road, the S Curve and Step Mountain Road) a distance of approximately 1.75 mile to get to the unmaintained segment of Step Mountain road that starts at lot 92. At that point they must travel approximately .75 miles on the unmaintained segment of Step Mountain Road to the frontage of their properties. The plaintiffs' lots are located on the 1.25 mile long segment of Step Mountain Road between Lot 76 and Lot 92 where there are no residences. This segment of Step Mountain Road has never been engineered and constructed to a standard where a building permit can be granted and annual maintenance can occur.¹³⁷ Part of that segment has been ruled by Salt Lake County to be too steep for safe access.¹³⁸ The fact that this segment of "road" is unmaintained has been interpreted as unfair by the plaintiffs as well as by Walt Hoffman, a previous owner of Mr. Atwood's Lot 99.¹³⁹

¹³⁰ Various Documents HCEII, Keith Emmer's Recollections, Page 119

¹³¹ Special Litigation Committee Interviews, Plaintiffs, April 28, 2010, Page 7, Line 314

¹³² Various Documents HCEII, Annual Meeting Minutes, June 11, 2005, Page 57

¹³³ Various Documents HCEII, Board Meeting Minutes, July 5, 2006, The Board decided to get a cost estimate. Page 65. The road was graded and a washed our area filled in fall of 2006. Tony Mascaro was paid for this work.

¹³⁴ Various Documents HCEII, Monthly Meeting Minutes, September 27, 2006, Page 66

¹³⁵ Special Litigation Committee Interviews, Plaintiffs, April 28, 2010, Page 7, Line 297

¹³⁶ Map, HCEII Non Buildable Land Area

¹³⁷ Map, Status of HCEII Roads

¹³⁸ Various documents HCEII, Directors Proposition 1992-D, Page 28

¹³⁹ Special Litigation Committee interviews, Walt Hoffman, Page 36, Line 1610

- J. The plaintiffs have claimed that the HCEII Directors are self dealing in that their property fronts on roads that have received more maintenance than the Plaintiffs' roads.¹⁴⁰

SLC Observation #7: All of the HCEII Directors live on roads shared by other members and maintenance began on their roads when building permits were issued. Their frontage does not differ from other frontage of other members on the roads that are maintained by HCEII. There is no evidence of self dealing and denying access to property by the Board

1. Rex Facer has maintained the roads periodically since the early 1980s. (The years he did not maintain the roads they were maintained by other contractors including Apache Sky, VanGo, Boyd Hansen and TNT General Contractors) Mr. Facer stated in his interview that he has never been asked by a board member to do special work on their road at the cost of the association.¹⁴¹
2. In their complaint, the plaintiffs included a photograph of Shaggy Mountain Road past Arlene Johnson's property as proof of self dealing. The lots 7, 10 and 5 that Arlene Johnson owns front on a relative flat grade and the area receives minimal traffic and does not develop washboard.¹⁴² That area does not receive annual grading.¹⁴³ No road maintenance or snow removal was done on this part of Shaggy Mountain road until the Johnson's received a building permit in summer of 1986.
3. Mountain Top Road was paved in 2006. This project was initiated by Rick Andrus, Board President. Mr. Andrus lived on Rose Canyon Road. Arlene Johnson presented the project at the 2005 annual meeting.¹⁴⁴ The project was justified in that Mountain Top Road was becoming costly to maintain and the patchwork that was previously done was not working.¹⁴⁵ Mountain Top Road receives a level of traffic second to Arnold Hollow Road and the area from which it collects traffic has received the second highest level of funding in the last fifteen years.¹⁴⁶ In the complaint, the plaintiffs showed photographs of Mountain Top Road as their evidence that Tony Sarra, Board Member, was self dealing. They also showed his paved driveway which he paid for himself. Tony Sarra as well as many other residents uses Mountain Top Road for daily ingress/ egress.¹⁴⁷
4. Keith Emmer and Tom Williams front on 14900 South and use it for ingress/ egress. This is the collector road for Mascaro Estates and often develops washboard due to the amount of traffic it receives.¹⁴⁸ Tony Mascaro voluntarily grades it as a favor to family members who use that road.¹⁴⁹ Maintenance began on 14900 South before Tom Williams and Keith Emmer were on the board.
5. Carol Dean's property is in the general location of Brandon Frank's lots 112 and 122C.¹⁵⁰ Her lot receives the same level of maintenance as all of the residential lots in Area D.¹⁵¹

¹⁴⁰ Special Litigation Committee Interviews, Plaintiffs, April 28, 2010, Page 14, Line 630

¹⁴¹ Special Litigation Committee interviews, Rex Facer, Page 16, Line 699

¹⁴² Section XII this Report, Photograph #11

¹⁴³ Special Litigation Committee interviews, Rex Facer, Page 20, line 894

¹⁴⁴ Various Documents HCEII, Annual meeting June 11, 2005, Page 56

¹⁴⁵ Special Litigation Committee Interviews, Rex Facer, Page 16, Line 743

¹⁴⁶ Various Documents HCEII, Hi Country Estates II Road Maintenance Patterns 1994 to 2009, Page 104

¹⁴⁷ Section XII of this report, Photograph #13

¹⁴⁸ Section XII of this Report, Photograph #12

¹⁴⁹ Special Litigation Committee Interviews, Rex Facer. Page 20 Line 906

¹⁵⁰ Map, Status of HCEII Roads

V. Snow Removal

Claim: The Board has given winter access rights to some lot owners (principally residents as opposed to nonresidents who are members) The association wastes and spends limited resources on winter snow removal for some roads but not all roads in the Association thus preventing some Association members from accessing their prosperities in the winter while others enjoy year round access

A. There are three types of snow removal service in HCEII.

SLC Observation #8: Snow is removed from roads that allow access to residents/homeowners. This is not due to neglect to fiduciary duties of the Board in that the Board has followed governing documents, are consistent with past practices and the Board has to operate within the funds actually available.

1. 15% of HCEII assessed units are properties owned by both residents and nonresidents located on Rose Canyon Road. They receive snow removal service from Salt Lake County. They do not need to access any HCEII owned roads for ingress/egress.
2. 69% of HCEII assessed units are properties owned by both residents and nonresidents located on roads maintained by HCEII receive snow removal from HCEII. All of the defendants in the lawsuit (with the exception of Carol Dean who has since resigned from the Board and moved out of state) are residents of HCEII and live on roads maintained by HCEII. The cost of snow removal from roads maintained by HCEII is covered by assessments shared by all members of the homeowners association.
3. 16% of the HCEII assessed units are properties owned by only nonresidents that are located on rough graded "roads" not regularly maintained by HCEII. These "roads" do not receive any snow removal because they do not lead to any residences. All three plaintiffs own property where there are no residents thus snow is not removed from their frontage. They travel on about 1 3/4 miles of HCEII maintained roads to get to the area where maintenance ends.

B. Justification for not removing snow on certain roads.

SLC Observation #9: Legal Counsel has advised the Board that they are in their right to remove snow only on roads that lead to residents in the same way they regularly maintain roads that lead to residents. While the plaintiffs' attorney may argue otherwise, the Board has chosen to follow the legal advice of the Attorney that the Board hired to advise them

1. In attempting to build a case to create a special snow removal assessment for only residents, Tom Chace, representing the Property Rights/ Greenbelt Group stated that land owners do not go to their roads in the winter "I have not talked to anyone who has un-built property that goes to their land in the winter. All they do is drive the road as they have no driveway or access off the road that is kept open in the winter. Many of the landowners

¹⁵¹ Section XII of this report, Photograph #10

don't even live in Salt Lake."¹⁵² In another email attempting to justify reducing assessments paid by nonresidents for snow removal Tom Chace made the statement "*The point is that most of this land (owned by nonresidents) has no driveway access and unless you go up each time it snows and clear a path, access through heavy snow would be very difficult. I don't understand how they use their land?*"¹⁵³

2. The Board considers snow removal for residents a safety responsibility in the same way they consider road maintenance a safety responsibility as spelled out in the Certificate of Incorporation. "*The Association is also formed to promote the health, safety and welfare of the residents within Hi Country Estates II.....*"¹⁵⁴ There are no residents on Step Mountain Road between Lots 92 and 76
3. As in road maintenance, snow removal for existing residences has been done since the early 1980s.¹⁵⁵ This has been a cost consideration and it is consistent with practices of local government.
- C. The Protective Covenants infer that even though nonresident members do not receive snow removal, they are still obligated to pay their share of the cost. "*Each grantee and lot owner for himself, his heirs, executors and assigns, covenants and agrees to pay annually his pro rata share of the costs to maintain roads, streets, and common areas*"¹⁵⁶ It is the opinion of Legal Counsel for HCEII that road maintenance includes snow removal.¹⁵⁷
- D. Tom Chace, representing the Property Rights/ Greenbelt Group, disputed snow removal as a safety issue. "*Using the safety issue is also debatable. This is a broad term and could also be applied to road conditions other than snow. There are places in the United States where the roads are not plowed. They drive them all winter and pack them out....*"¹⁵⁸

¹⁵² Keith Emmer's Email. Email Tom & Lenell Chace to Keith Emmer, April 28, 2009, Page 79

¹⁵³ Keith Emmer's emails, Tom Chace to Keith Emmer, May 3, 2009, Page 95

¹⁵⁴ Certificate of Incorporation, Hi-Country Estates Homeowners Association; Third Article

¹⁵⁵ Special Litigation Committee Interviews, Rex Facer, Page 15, Line 668

¹⁵⁶ Protective Covenants for Hi Country Estates Phase II, Article II, Section 2

¹⁵⁷ Keith Emmer's Emails, Letter from Howard Lundgren to Keith Emmer dated May 6, 2009, Page 104

¹⁵⁸ Keith Emmer's Email. Email from Tom & Lenell Chace to Keith Emmer, Monday May 4, 2009, Page 97

VI. Architectural Control Committee

Claim: The Architectural Control Committee (ACC) has prepared a policy even though the governing documents do not allow the ACC to enact or create any such policy.

A. Pursuant to Article VII, Section 1(a) of the Bylaws, *"The Board of Directors shall have the power to (a) adopt and publish rules and regulations governing the use of roads, streets, common areas, properties and facilities owned or under the control of the Association"*¹⁵⁹ In November 2004 it was recommended by legal counsel that a policy and procedure manual was needed for the purpose of consistency and clarification.

1. The need for a policies and procedures manual was presented to the membership by Tony Sarra and Shane Capaldi in the June 11, 2005 annual meeting.¹⁶⁰ In the July 6, 2006 director's meeting Dave Winters, an association member as well as the Zoning Enforcer for Herriman City, stated that the ACC will write a policies and procedures (manual) in order to be consistent.¹⁶¹
2. The assessment of fines for Protective Covenant violations was suggested by Dave Winters in the August 9, 2006 meeting.¹⁶² Legal counsel advised Keith Emmer that even though the documents do not give a specific amount of fines, it can be done in a book of policies and procedures.¹⁶³ On July 28, 2008 the ACC sent out a letter to all of the membership letting them know that they were in the process of compiling a policies and procedures manual.¹⁶⁴
3. As of May 2010, no fines have been assessed on the plaintiffs or any Association members for animal related issues. No fines have been collected from anyone in the Association.¹⁶⁵

B. The June 12, 2009 Demand letter states that the ACC *"policy attempts to restrict certain property owners ability to maintain their properties in greenbelt status and to burden historic grazing operations with new standards and requirements"*.

SLC Observation # 10: The plaintiffs are not impacted by the ACC's policy in that they have not submitted any applications to the ACC nor have any activities on their properties been questioned, noted, cited or denied by the ACC.

1. Historically, open, summer grazing of cattle qualified members for greenbelt. Individuals, not the Board, were responsible for greenbelt qualification.¹⁶⁶ The Board was brought into discussions regarding greenbelt when the cattle became a nuisance to members by grazing

¹⁵⁹ Bylaws of Hi-Country Estates Homeowners Association Phase II, INC

¹⁶⁰ Various Documents HCEII, Annual Meeting Minutes, June 11, 2005, Architectural Control Committee Report, Shane Capaldi and Legal Report, Tony Sarra, Page 56

¹⁶¹ Documentation of the Architectural Control Committee, HCEII Board meeting July 5, 2006, Page 7

¹⁶² Documentation for the Architectural Control Committee, HCEII Board meeting, August 9, 2006, Page 8

¹⁶³ Documentation for the ACC, email Annette Emmer to Terri Williams dated Saturday July 26, 2008, Page 9

¹⁶⁴ Documentation for the Architectural Control Committee, Letter to HCEII Members, July 28, 2008, Page 12

¹⁶⁵ Special Litigation Committee Interviews, Terri Williams Page 27, Line 1198

¹⁶⁶ Various Documents HCEII, Annual Meeting Minutes 1992, Page 13

on irrigated lawns.^{167 168 169} Open, summer, cattle grazing came to an end on June 10, 2008 when members who were on greenbelt were informed by the Salt Lake County Assessor that their property could no longer be qualified by Lon Burrow's open cattle grazing.^{170 171} At the June 14, 2008 Annual HCEII Meeting, Tom Chace suggested that lot owners coordinate to fence in combined parcels and obtain animals to qualify for greenbelt. Walt Hoffman moved to form a committee to address greenbelt issues.¹⁷² In July of 2008, Bob Chew brought his horses to HCEII to qualify some properties for greenbelt and there was positive interaction with the ACC.¹⁷³ Mr. Chew's intent was to keep the horses in HCEII year round, not just for the summer. In October 2008, Terri Williams verbally reminded Tom Chace that Bob Chew's horses need to have shelters.^{174 175} Other members, including residents, have received similar reminders.^{176 177 178}

2. Year-round horse grazing in fenced areas has not historically been used for greenbelt qualification on an association-wide scale until the Property Rights/ Greenbelt Committee introduced Bob Chew and his horses to some properties in HCEII. Not all members who have horses can qualify for greenbelt because their lots are less than five acres in size. Some people qualify for greenbelt with horses other than Bob Chew's horses. Some people qualify for greenbelt by other means such as cattle, burros or honeybees.
3. The Plaintiffs are currently receiving a greenbelt property tax break and they are on the list of properties submitted to Salt Lake County to be qualified for greenbelt by Bob Chew.^{179 180} Tom Chace has horses on his property for only the summer and the property is fenced. His fence was approved by the ACC.¹⁸¹ None of the three plaintiffs have horses or any indication of grazing operations on their properties. Their lots are not fenced and there are no shelters, horse corrals or feeding areas. None of the plaintiffs have submitted applications or requests to the ACC. Discussions involving ACC control of grazing operations do not appear relevant to their situation.

¹⁶⁷ Various Documents HCEII, Letter to Board of Directors from Tom Chace, Lenell Chace, Nancy McGahey and Dan McGraw Dated June 18, 2001, Page 50

¹⁶⁸ Various Documents HCEII, Letter to David Yocom, Salt Lake County Attorney from concerned residents of the Rose Canyon Area, June 26, 2001, Page 52

¹⁶⁹ Various Documents HCE II, The Salt Lake Tribune, *Council Delays Cattle Decision in Hopes Residents Will Settle Tiff*, August 2, 2001, Page 54

¹⁷⁰ Keith Emmer's Emails, Keith Emmer to Board, Dec. 17, 2007, Page 1

¹⁷¹ Various Documents HCEII, Letter from Susan Yoshinaga to HCEII, June 10, 2008, Page 73

¹⁷² Various Documents HCEII, Annual Meeting Minutes, June 14, 2008, Page 74

¹⁷³ Documentation for the ACC, email from Terri Williams to the Board, Tuesday, July 29, 2008, Page 13

¹⁷⁴ Keith Emmer's Emails, Terri Williams to Keith Emmer, Wednesday October 8, 2008, Page 18

¹⁷⁵ Protective Covenants, Article I, Section 11,

¹⁷⁶ Special Litigation Committee Interviews, Terri Williams, Page 30, Line 1373 and 1383

¹⁷⁷ Special Litigation Committee Interviews, Robert Messmer, He has horses, is not on Greenbelt and received a letter regarding shelter, Page 51, Line 2335

¹⁷⁸ Documentation for ACC, Letters sent to people who have horses without shelter, Jan. 25, 2009, Page 3

¹⁷⁹ Salt Lake County Assessor's online records

¹⁸⁰ Documentation for ACC, Letter from the Greenbelt Committee to the ACC, January 7, 2009, Page 34

¹⁸¹ Documentation for the ACC, Fencing Application- Tom and Lenell Chace, Page 17

4. Tom Chace let Keith Emmer know that there may not be horses on all of the property that Bob Chew is qualifying. He also wanted the Board to sign a contract with Bob Chew but Keith declined the offer.¹⁸²
- c. Mr. Budge stated to the SLC: *"Historically they (the ACC) completely, totally changed all the rules. The other thing that needs to be voted into the analysis, Mr. Wilson, is you cannot try to control uses on that, within that subdivision or within the project in a way that doesn't comply with historic norm for regulating those and that's based out of Utah law."*¹⁸³ Mr. Budge feels that since the County does not require horse shelters the HOA cannot require them.¹⁸⁴

SLC Observation #11: This claim involves a difference in legal opinions between Howard Lundgren and Wade Budge. The Board has followed the advice of Howard Lundgren because he is their legal counsel.

- 1 Salt Lake County increased land development restrictions when FCOZ was adopted in 1997.¹⁸⁵ A comparison of the zone FA2.5¹⁸⁶ (Lots 99, 100 and 102 are in this zone), FCOZ and the HCE II Protective Covenants will show that the HCEII Protective Covenants are more restrictive because they require setbacks and a minimum floor area for a dwelling.
- 2 The FR5 zone, where Mr. Atwood's lot 98 resides, lists horses as a conditional use subject to FCOZ review and approval.^{187 188} If horse grazing is considered "historic norm" then "historic norm" was not a consideration in the zoning of Mr. Atwood's lot 98 by Salt Lake County.
- 3 The Special Litigation Committee asked the plaintiffs where the documents state that a Policies and Procedure manual would be forbidden. Wade Budge responded: *"It's the other way; it's not what's forbidden it's what's allowed. In other the words the CC&Rs sets the baseline on what the board may do by way of regulations. They don't open the gate and allows us continually expansive readings and the reasons is, is because when you are someone who is starting a subdivision and there's a lot of case law in this, you set the standard or the baseline for everyone's expectations based on the initial governing documents and you cannot then encroach upon those property rights that are maintained by everyone else by changing your interpretation and expanding your requirements. The reason being that any time you grant someone the right to regulate your property that grant is limited to the terms in that specific grant cause it's important that when there is any sort of question that the rights of the property owners be maintained; an example would be there's a lot of litigation in Florida about this issue and in Florida there are situations whereas property values would increase, see new owners would come in and try and get new interpretations of the long standing CC&R's and they would do so cause maybe they were going to remodel their homes in a way that was inconsistent with the way it had been done historically and so the courts have come down and said they're not going to allow you to do something that would constitute substantial change in the way it had been done previously."*

¹⁸² Keith Emmer's emails, Keith Emmer to Bob Dean, September 26, 2008, Page 15

¹⁸³ Litigation Committee Interviews, Plaintiffs, April 28, 2010 Page 19, Line 874

¹⁸⁴ Special Litigation Committee Interviews, Plaintiffs, April 28, 2010 Page 19, Line 882

¹⁸⁵ Various Documents HCEII, Cal Schneller, March 23, 2010, Page 112

¹⁸⁶ Chapter 19.54 FA-2.5, FA-5, FA-10 AND FA-20 FOOTHILL AGRICULTURE ZONES (From Salt Lake County Government Web Site <http://WWW.co.sl.c.ut.us/>)

¹⁸⁷ C-1 Chapter 19.12 FR-0.5, FR-1, FR-2.5, FR-5, FR-10, FR-20, FR-50 AND FR-100 FORESTRY AND RECREATION ZONES (From Salt Lake County Government Web Site <http://WWW.co.sl.c.ut.us/>)

¹⁸⁸ C-2 Chapter 19.72 FOOTHILLS AND CANYONS OVERLAY ZONE (FCOZ) (From Salt Lake County Government Web Site <http://WWW.co.sl.c.ut.us/>)

*The examples would be they were mobile homes and now they are all mansions on a golf course. They can't now change that particular subdivision in a way that is more restrictive than it was when it was created."*¹⁸⁹

- D. The June 12, 2009 demand letter questions the authority of the Policies and Procedures Manual and states that it is inconsistent with governing documents.
1. As set forth in A of this section, the Bylaws of the organization specifically allow the adoption of rules and regulations to govern the use of properties under the control of the association. The ACC justified the level of detail based on the Protective Covenants: *"Any animals to be kept outside shall be housed and managed, based upon a plan for such housing and management, which shall have had prior Architectural Control Committee Approval."*¹⁹⁰
 2. No standards for housing and management were included in the Protective Covenants. "Housing" is interpreted as shelter. "Management" is interpreted as providing food and water for grazing animals. The ACC determined that the standards used by the Humane Society would provide the detail needed to be consistent. These standards are referenced in the Policy and Procedures Manual as worded in C-1 above.^{191 192}
 3. The June 12, 2009 Demand letter cites, Page 9, section 5. Livestock, of the Policies and Procedures Manual an example and makes the statement: *"... The Policy attempts to specify the type and quantity of hay and the type of shelters that must be maintained for people to enjoy agricultural uses.Unfortunately the Board has sanctioned an effort to change the nature and general plan of the Association from one where agriculture uses are allowed and fostered to one where they are discouraged in favor of residential uses."*

SLC Recommendation #3: On Page 11, Clarification of Protective Covenants and Bylaws, Section 7-f, the documents states "Structure must have County Conditional use approval." This is covered on Page 8, Section 1 - e. "Compliance with state and county regulation rests with the owner". Property owners are required to get the proper permits from Salt Lake County by County ordinance. The ACC should not be accountable for an owner's obtaining County approval. It is recommended that the Board amend the document so that Page 11, Chapter 5, Section f. is removed.

Page 9, Section 5. Livestock:¹⁹³

- d. *Animals must be housed and managed*
 - i. *Adequate food and water*
 1. *Adequate water is defined as access to drinking water at all times (per Humane Society recommendations)*
 2. *For all grazing animals where pasture is depleted, adequate food is defined as a minimum of 1.5 pounds of clean hay per 100 lbs per animal daily (per Humane society recommendations)*
 - ii. *Adequate shelter*
 1. *Permanent Shelter*
 2. *Temporary Shelter*

¹⁸⁹ Special Litigation Committee Interviews, Plaintiffs, April 28, 2010 Page 20 Line 915

¹⁹⁰ Protective Covenants, Article I, Section 11

¹⁹¹ HCEII Architectural Control Committee, Policies and Procedures Manual, Page 9

¹⁹² Special Litigation Committee interviews, Terri Williams, Page 23, Line 1022

¹⁹³ ACC Policies and Procedures Manual, Page 9

See clarifications section for additional information

*Clarification of Protective Covenants and Bylaws*¹⁹⁴

(Chapter 5) Clarification of Temporary Shelter for Livestock

- a. Structure must be removable within 48 hours
 - b. Structure cannot have a permanent foundation
 - c. ACC will inspect property within seven (7) days after installation of removal of temporary structure to insure all stipulations are met
 - d. Materials must be durable enough for the length of use and the intended purpose.
 - e. Owner and/or lessee is responsible for maintenance of shelter and must insure that the structure does not become a nuisance and or visually offensive
 - f. Structure must have County Conditional use approval and this document must be presented for approval of the shelter to the ACC.
- E. During the winter of 2009 there were a series of complaints from members to the ACC about the treatment of horses owned by Bob Chew. These complaints included improper housing, neglect, lack of food, loose horses and a dead horse^{195 196} Keith Emmer contacted Tom Chace about these complaints.¹⁹⁷
1. Tom Chace, representing the Property Rights/ Greenbelt Committee, took responsibility to manage lots where Bob Chew's horses grazed. In one case Mr. Chace requested all communication to be sent to the Group Greenbelt Committee due to the legal action against the HCEII HOA and the ACC.^{198 199 200} According to Terri Williams, Mr. Miyagi (other than Tom Chace) was the only member of Group Greenbelt that sent fence plans to the ACC for approval.²⁰¹ It is not clear why Tom Chace, as the committee leader, submitted the fencing plans for his own property to the ACC but the rest on the Greenbelt Group did not submit plans as individuals. The ACC felt that the Property Rights/ Greenbelt Committee wanted special treatment from the ACC and the County.²⁰²
 2. Tom Chace stated "*The main reason properties are in greenbelt is because the property cannot be developed. These property owners are far more concerned about building on their land than maintaining greenbelt.*"²⁰³

¹⁹⁴ ACC Policies and Procedures Manual, Page 11

¹⁹⁵ Documentation for the Architectural Control Committee, Feb 2, 2009, note to ACC from Terri Williams, Page 39

¹⁹⁶ Special Litigation Committee Interviews, Terri Williams, Voice mail left by Animal Control Officer on Terri Williams phone stating that a horse had to be put down. Page 29, Line 1330

¹⁹⁷ Keith Emmer's Emails, Keith Emmer to Tom Chace, March 4, 2009, page 49 & 50

¹⁹⁸ Special Litigation Committee Interviews, Terri Williams, Page 22, Line 998

¹⁹⁹ Documentation for the ACC, Letter to Ms Taylor from the AAC dated November 23, 2009, Page 48

²⁰⁰ Documentation for the ACC, Letter from Group Greenbelt Committee to HCEII, December 16, 2009, Page 49

²⁰¹ Special Litigation Committee Interviews, Terri Williams, Page 25, Line 1123.

²⁰² Special Litigation Committee Interviews, Terri Williams, Mr. Ely complained that he had to follow FCOZ but Tom Chace did not, Page 23, line 1009

²⁰³ Keith Emmer's emails, Tom Chace to Keith Emmer, January 8, 2009, Page 44

VII. Greenbelt

Claim: The Board has allowed the creation of policies to deny individuals the benefit of a preferred property tax benefit known as "greenbelt" status. A Board member has contacted Salt Lake County to determine what can be done to disqualify land within the Association from being treated as greenbelt.

SLC Observation #12: No evidence was produced by the plaintiffs that the ACC recommendations have denied the plaintiffs of greenbelt status or that a Board member has attempted to disqualify land within the Association of greenbelt. None of the plaintiffs have lost greenbelt status.

- A. The majority of the land area in HCEII is on greenbelt.²⁰⁴ 53% of the voting units and 66% of the land area are in Greenbelt.²⁰⁵ Bob Chew (he is the owner of the horses and he is coordinated by the Greenbelt Committee) qualifies 30% of the HCEII voting units and 37% of the land for greenbelt with his horses.²⁰⁶ The remaining 23% of voting units and 29% of the land are qualified for greenbelt by other means.²⁰⁷
- B. Susan Yoshinaga, Greenbelt Manager for Salt Lake County Assessor's Office, stated that no one has involuntarily lost greenbelt status in the last two years.²⁰⁸ Bob Chew qualifies most of the people in HCEII and none of the people he qualifies are at risk of losing that status. The HCEII Board has nothing to do with that status.²⁰⁹
- C. In the SLC interview, the plaintiffs were asked what actions were taken by the Board to interfere with Greenbelt status. They responded that it was the entire Board because they approved the ACC recommendations.²¹⁰ Tom Chace expressed his frustration with the ACC's involvement with the fencing that was needed for livestock that qualified members for greenbelt in an email dated December 9, 2008.²¹¹ Tom Chace stated that Susan Yoshinaga told him that she received complaints that the land is not suitable for greenbelt and should not have that status.²¹² The plaintiffs' Attorney could not identify a Board member that he assumed had contacted Salt Lake County to disqualify land within the Association from being treated as greenbelt.²¹³
- D. In an email dated April 6, 2009, Tom Chace stated "*The greenbelt Property Owners can't understand why the Board and ACC seem determined to interfere with their greenbelt issues. They perceive that the goal is to make the HCEII parameters of compliance more and more impossible so that the requirement cannot be met. They cannot understand the reasoning behind the time consuming effort to monitor the horses to "make sure they are in compliance*

²⁰⁴ Map, Land Qualified for Greenbelt.

²⁰⁵ Salt Lake County Assessor's Records (From Salt Lake County Government Web Site <http://WWW.co.slc.ut.us/>)

²⁰⁶ Documentation for ACC, Email from Greenbelt Committee to ACC, January 7, 2009, Attachment, Page 35

²⁰⁷ Salt Lake County Assessor's Records (From Salt Lake County Government Web Site <http://WWW.co.slc.ut.us/>)

²⁰⁸ Special Litigation Committee Interviews, Plaintiffs, April 28, 2010, Wade Budge agreed, Page 21, Line 968

²⁰⁹ Various Documents HCEII, Communication between Susan Yoshinaga and Arlene Johnson, Page 109

²¹⁰ Special Litigation Committee Interviews, Plaintiffs, Page 20, Line 951

²¹¹ Documentation for ACC, Tom Chace to the ACC, December 9, 2008, Page 27

²¹² Keith Emmer's Emails, Tom and Lenell Chace to Keith Emmer, April 6, 2009, Page 55

²¹³ Special Litigation Committee Interviews, Plaintiffs, Page 21, Line 956

*and report back to the Assessor" from a governing body that is supposed to be on our side and didn't have time to help with keeping us in greenbelt. Susan (Yoshinaga) has told me that the calls she has received complain that land is not suitable for greenbelt and should not have that status"*²¹⁴

- E. Susan Yoshinaga stated that no Board member has tried to get anyone off greenbelt. For years, residents in Rose Canyon have complained about roaming livestock from people on greenbelt. This dates back to Tony Mascaro.^{215 216} Susan Yoshinaga is not aware of any HCEII policies that were designed to deny individuals of greenbelt status.²¹⁷
- F. The HCEII Board has historically taken a hands-off approach to greenbelt. They are not responsible for greenbelt status impact resulting from decisions made by the State of Utah, Salt Lake County or the Association Member.^{218 219 220 221 222}

²¹⁴ Keith Emmer's Emails, Tom and Lenell Chace to Keith Emmer, April 6, 2009, Page 55

²¹⁵ Various Documents HCEII, Communication between Susan Yoshinaga and Arlene Johnson, Page 110

²¹⁶ Special Litigation Committee Interviews, Plaintiffs, April 28, 2010, Wade Budge could not remember which Board member had contacted the Assessor about disqualifying greenbelt land, Page 21 Line 956

²¹⁷ Various Documents HCEII, Communication between Susan Yoshinaga and Arlene Johnson, Page 109

²¹⁸ Special Litigation Committee interviews, Keith Emmer, Page 1, Line 42

²¹⁹ Various Documents HCEII, Annual Meeting Minutes 1992, Bill 45, The Utah Farmland Assessment Act, Page 15

²²⁰ Various Documents HCEII, Letter from "The Cow Committee" to the Board of Directors, June 18, 2001. Page 50

²²¹ Various Documents HCEII, Letter from individuals opposed to open grazing as a way for members to qualify for greenbelt to Dave Yocom, SLCo Attorney, June 26, 2001, The person who grazes the cattle (Lon Burrows) has an agreement with individuals, not HCEII, Page 52

²²² Various Documents HCEII, Annual meeting Minutes, June 14, 2008, last paragraph, Keith Emmer stated that the Board never coordinated Greenbelt status. Page 75

VIII. Gate Keys

Claim: The Board has allowed the installation of gates and not provided keys to members within the Association including the Plaintiffs.

SLC Observation # 13: This should have not been included in the claim in that the plaintiffs and their attorney knew five months before the claim was filed that the gate had been unlocked.

- A. Two gates were installed on Step Mountain Road.²²³ Keys were issued by Tom Williams. Mr. Atwood was provided keys to both the upper and the lower Step Mountain Gates. Mr. Gilmore was provided keys to both gates on two occasions. Mr. Frank never requested a key from Tom Williams.²²⁴ Keith Emmer stated that Brandon Frank came to his house and Mr. Emmer gave Mr. Frank a key.²²⁵ During the time the gates were locked, Mr. Frank was behind on his assessments and should not have been given a key.^{226 227} When he paid his back assessments of \$1,372 on December 2, 2009 for lot 102, the upper gate had been unlocked for five months.²²⁸ When the complaint was filed on November 25, 2009, the upper gate had been unlocked for five months and the plaintiffs' attorney, Wade Budge, had been informed of this by Howard Lundgren three months before the lawsuit was filed.²²⁹
- B. The upper gate is located south of the plaintiffs' property. In the June 2009 Annual Meeting, Scott Royal, a property owner above the gate, requested that the upper gate be unlocked. It was unlocked after the 2009 annual meeting and is currently unlocked.
- C. The lower gate is located to the northwest of the plaintiffs' property. It was left locked in order to discourage ORVs from driving up the steep gully leading to Step Mountain (Step Mountain Road) No requests from the plaintiffs to unlock this gate are known.

²²³ Map, Status of HCEII Roads

²²⁴ Various Documents HCEII, Written statement from Tom Williams regarding Step Mountain Gates, March 6, 2010, Page 108

²²⁵ Various Documents HCEII, Recollections of statements, Keith Emmer, Page 119

²²⁶ Certificate of Incorporation, Addendum Section IV,

²²⁷ Various Documents HCEII, Monthly Meeting Minutes, November 24, 2008, Page 118

²²⁸ HCEII Financial Records

²²⁹ Various Documents HCEII, Letter to Wade Budge from Howard Lundgren, September 1, 2009. Mr. Budge, Plaintiffs' Attorney, was told the gates were unlocked. Page 92

IX. 2009-10 Budget.

Claim: The Association is operating without a budget.

SLC Observation #14: Legal Counsel has advised the Board that they do not need a membership vote to establish a budget. Where an issue results in a conflicting interpretation of the law between attorneys, the Board's most responsible option is to listen to the opinion of the Attorney they have hired to represent them.

- A. The plaintiffs questioned the line item for legal fees in the 2009-2010 budget presented in the 2009 annual meeting.²³⁰ The plaintiffs attempted to block the budget by proposing a hand vote at the meeting.²³¹ They claim that their hand vote represented the majority of the voting units present at the meeting thus they had the power to approve or deny the passing of the budget.
- B. A review of the governing documents has found nothing that states a membership vote is necessary to pass or adopt a budget. Past annual meetings do not consistently reflect attending membership votes regarding the budget.
- C. Plaintiffs were asked by the Special Litigation Committee to point out in the governing documents where it states that the association is obligated to get member approval for the budget. Their Attorney, Wade Budge, stated that would be addressed as legal issue; they have no comment at this time.²³²

²³⁰ Various Documents HCEII, Proposed 2009 -2010 Budget, Page 81

²³¹ Recording of the 2009 Annual Meeting

²³² Special Litigation Committee interviews, Plaintiffs, April 28, 2010, Page 2, Line 65

X. Resolution

Claim: The Plaintiffs have tried to resolve issues with the HCEII Board.

- A. In the November 2008 monthly meeting there were discussions about the condition of roads fronting the plaintiffs' properties, the philosophies behind prioritizing road maintenance, County zoning, sewer, water rights and annexation.²³³ Mr. Atwood threatened to bury the association in legal fees.²³⁴ Tom Williams stated that after the November 24, 2008 meeting Mr. Atwood stopped him in the parking lot and made a statement that "you have not seen anything yet."
- B. The Greenbelt Committee expanded its scope to the Property Rights Committee.²³⁵ Tom Chace also represented the Greenbelt Committee as "Group Greenbelt".²³⁷ Tom Chace provided almost all of the email communication between the Board and the Property Rights Committee.²⁴⁰ He refused to meet with the Special Litigation Committee and it is unclear what communication he has had with the three plaintiffs.²⁴⁴
- C. In December 2008 Keith Emmer responded to accusations from Tom Chace regarding the Board being resentful to greenbelt, having no respect for those who cannot build, and generally not supporting development.²⁴⁵ Tom and Lenell Chace stated that the Property Rights Committee "has one simple goal – to do anything we can to make it possible for un-built property to be developed."²⁴⁶
- D. At the March 28, 2009 monthly meeting, the Board presented information regarding development issues.²⁴⁷ Tom Chace was complimentary of the effort with the exception that greenbelt issues were not presented.²⁴⁸
- E. The demand letter was written on June 12, 2009.²⁵⁰ Howard Lundgren, the defendants' attorney, and Wade Budge, the plaintiffs' attorney, exchanged telephone conversations and emails after the demand letter was received. Howard Lundgren recapped the conversations "As I told you in

²³³ Various Documents HCEII, Monthly Meeting Minutes, November 24, 2008, Page 118

²³⁴ Various Documents HCEII, Keith Emmer's Recollections, Page 119

²³⁵ Keith Emmer's Emails, Tom Chace to Keith Emmer, December 7, 2008, email signed "Tom and Lenell Chace The Property Rights Committee and The Greenbelt Committee" Page 35

²³⁶ Keith Emmer's Emails, Tom Chace to Keith Emmer, March 31, 2009, Page 52

²³⁷ Keith Emmer's Emails, Tom Chace to Keith Emmer, April 6, 2009, Page 55

²³⁸ Documentation for the ACC, Tom and Lenell Chace to Terri Williams and Rob Dean, December 15, 2008, Page 30

²³⁹ Documentation for the ACC, Group Greenbelt Committee to HCEII ACC, December 16, 2009, Page 49

²⁴⁰ Keith Emmer's Emails, Tom Chace to Keith Emmer, April 27, 2009, Page 77

²⁴¹ Keith Emmer's Emails, Tom Chace to Keith Emmer, April 28, 2009, Page 79

²⁴² Keith Emmer's Emails, Tom Chace to Keith Emmer, May 3, 2009, Page 83

²⁴³ Keith Emmer's Emails, Tom Chace to Keith Emmer, May 4, 2009, Page 96-97

²⁴⁴ Various Documents HCEII, Conversation between Arlene Johnson and Tom Chace, Feb. 10, 2010, Page 106

²⁴⁵ Keith Emmer's Emails, Keith Emmer to Tom Chace, December 15, 2008, Page 39

²⁴⁶ Keith Emmer's Emails, Tom Chace to Keith Emmer, January 8, 2009, Page 44

²⁴⁷ Electronic Copy of the Power Point presentation is available from Tony Sarra

²⁴⁸ Keith Emmer's Emails, Tom & Lenell Chace to Keith Emmer, March 31, 2009, Page 53

²⁴⁹ Keith Emmer's Emails, Tom & Lenell Chace to Keith Emmer, April 6, 2009, Page 55

²⁵⁰ Various Documents HCEII, Claim and Written Demand, June 12, 2009, Page 86

our initial conversation, my letter of July 1, 2009, our second conversation in late July 2009 and my email of August 6, 2009 the Board of Directors of Hi Country Estates Homeowners Association Phase II is ready, willing and able to begin a dialogue with group greenbelt, the Property Rights Committee and your individual clients regarding the issues raised in your June 12, 2009 letter and the draft complaint which you provided with your August 19, 2009 letter "²⁵¹

- F. In a letter from Wade Budge to Howard Lundgren dated August 19, 2009, Mr. Budge stated that his clients wanted concessions to the items brought out in the June 12, 2009 Demand letter. Mr. Budge stated that his clients were especially interested in roads, greenbelt and bars to nonresident involvement on Boards²⁵² He attached a copy of a draft complaint " Hi-Country Property Rights Group, Lindsay Atwood, Tom Chace, Lenell Chace, Jerry Gilmore and Brandon Frank vs. Hi-Country Estates Homeowner's Association Phase II"²⁵³
- G. On September 1, 2009 Howard Lundgren responded to Wade Budge and suggested using a mediator before litigation is filed. ²⁵⁴ No meeting with the Attorneys or a mediator was set up. Instead Tony Sarra met with Tom Chace on September 8, 2009 to discuss the various issues.
- H. In the September 8, 2009 meeting, Tom Chace stated to Tony Sarra that greenbelt was the least of the Property Rights Committee's concerns. Their interest is in developing their properties. The priority was to get out from under FCOZ restrictions, getting sewer installed and deal with roads and water. Further, they want all issues resolved together and are unwilling, to quote, "salami" these into separate initiatives. At this meeting it became clear for the first time that greenbelt was not their main concern. Tony told Tom Chace that he did not think the wording of the June 12, 2009 demand letter was clear and a meeting to clarify that would be helpful. ^{255 256}
- I. On September 10, 2009 Howard Lundgren sent Wade Budge a notice that the Board had elected to form a Special Litigation Committee. He asked Mr. Budge to provide specific bases for allegations and evidence that the Board has violated its fiduciary duty to the association in regards to maintaining the roads. ²⁵⁷ That was never received.
- J. Keith Emmer told Tom Chace that the Board is willing to meet with the Property Rights Committee but legal counsel had advised that Tony Sarra and Arlene Johnson not meet in any negotiations because they were on the Special Litigation Committee and they must remain independent from the negotiations. He suggested that if the June 12, 2009 demand letter were rescinded then it would be possible for the full board to meet with them ^{258 259 260} Tom Chace sent

²⁵¹ Various Documents HCEII, Howard Lundgren to Wade Budge, September 1, 2009, Page 92

²⁵² Various Documents HCEII, Letter to Howard Lundgren from Wade Budge, August 19, 2009, Page 91

²⁵³ Keith Emmer's Emails, Draft Complaint, August, 2009, Page 117

²⁵⁴ Various Documents HCEII, Howard Lundgren Letter to Wade Budge, September 1, 2009, Page 93, last paragraph

²⁵⁵ Keith Emmer's emails, Tom Chace to Keith Emmer, October 10, 2009, Page 132

²⁵⁶ Recollection by Tony Sarra of a lunch meeting with Tom Chace on September 8, 2009,

²⁵⁷ Various Documents HCEII, Letter to Wade Budge from Howard Lundgren, September 10, 2009, Page 95

²⁵⁸ Keith Emmer's emails, Keith Emmer to Tom Chace, October 8, 2009, Page 133

²⁵⁹ Keith Emmer's emails, Keith Emmer to Tom Chace, October 12, 2009, Page 132

²⁶⁰ Keith Emmer's Emails, Keith Emmer to Tom Chace, October 13, 2009, Page 134

email to Keith Emmer stating "If the entire Board is not willing to meet Then we will proceed with filing a lawsuit against the HOA and members of the Board individually." ²⁶¹

- K. On October 14, 2009 Keith Emmer, Carole Dean, Kim Wilson, Lindsay Atwood, Tom Chace, Lenell Chace, Jerry Gilmore and Brandon Frank met. The content of the meeting did not relate to the concerns set forth in the June 12, 2009 demand letter or the draft complaint or Wade Budge's letter dated August 19, 2009. Lindsay Atwood stated that the threat of a lawsuit would go away if the Board would support them in convincing the membership to annex to Herriman and bonding for improvements. ^{262 263 264 265} In the interview with the Special Litigation Committee, Mr. Atwood stated that Herriman City had not promised them anything. ^{266 267} Tom Chace has promoted getting out of unincorporated Salt Lake County in order to get out from under FCOZ. ^{268 269 270} The Property Rights Committee said in a letter to the membership that Herriman would remove the Salt Lake County Foothills and Canyons Overlay Zone (FCOZ). ²⁷¹
- L. Tom Chace told Arlene Johnson that after the meeting on October 14, 2009 Tom and Lenell Chace broke away from the group. Tom and Lenell Chace refused to meet with the Special Litigation Committee. ²⁷²
- M. On October 23, 2009, one month before the complaint was filed, Lindsay Atwood sent an email to Keith Emmer stating that he believed the Board had no interest in settling the lawsuit in that they had not responded to the requests he made at the October 14, 2009 meeting. ²⁷³ Keith Emmer informed Lindsay Atwood that the association's attorney has instructed the board that they must remain neutral on annexation to Herriman. Keith offered to facilitate a meeting with the membership where Lindsay's group could present their ideas on annexation. ²⁷⁴ Mr. Atwood forwarded Keith Emmer's offer to set up a meeting on annexation to Wade Budge, Tom Chace, Brandon Frank and Jerry Gilmore but they did not respond to Keith Emmer's offer. ²⁷⁵
- N. A meeting was scheduled on November 11, 2009 in Howard Lundgren's office to attempt to discuss issues. All of the Board was present but the Plaintiffs did not show up. The plaintiff's Counsel left Mr. Lundgren a voicemail approximately 30 minutes before the scheduled meeting time to advise that he and the plaintiffs would not be attending the meeting and apologized for his clients' "unprofessionalism".
- O. The complaint was filed on November 25, 2009.
- P. The plaintiffs met with the Special Litigation Committee on April 28, 2010. Their responses relative to the complaint are throughout this document.

²⁶¹ Keith Emmer's Emails, Tom Chace to Keith Emmer, signed Property Rights Litigation Committee, October 12, 2009, Page 134

²⁶² Keith Emmer's Emails, Keith Emmer to Howard Lundgren, October 15, 2009, Page 135

²⁶³ Various Documents HCEII, email Kim Wilson to Howard Lundgren, Page 97

²⁶⁴ Various Documents HCEII, Keith Emmer's Recollections, Page 119

²⁶⁵ Various Documents HCEII, Letter Property Rights Committee to HCEII Property Owners, May 6, 2010, Page 137

²⁶⁶ Special Litigation Committee Interviews, Plaintiffs, April 28, 2010, Page 21 Line 974

²⁶⁷ Special Litigation Committee Interviews, Plaintiffs, April 28, 2010, Page 21 Line 974

²⁶⁸ Keith Emmer's emails, Tom and Lenell Chace to Keith Emmer, June 21, 2008, Page 3

²⁶⁹ Keith Emmer's emails, Tom and Lenell Chace to Keith Emmer, September 22, 2008, Page 13, 14

²⁷⁰ Keith Emmer's Emails, Tom Chace to Keith Emmer, October 24, 2008, Page 30, last paragraph

²⁷¹ Various Documents HCEII, Letter Property Rights Committee to HCEII Property Owners, May 6, 2010, Page 139

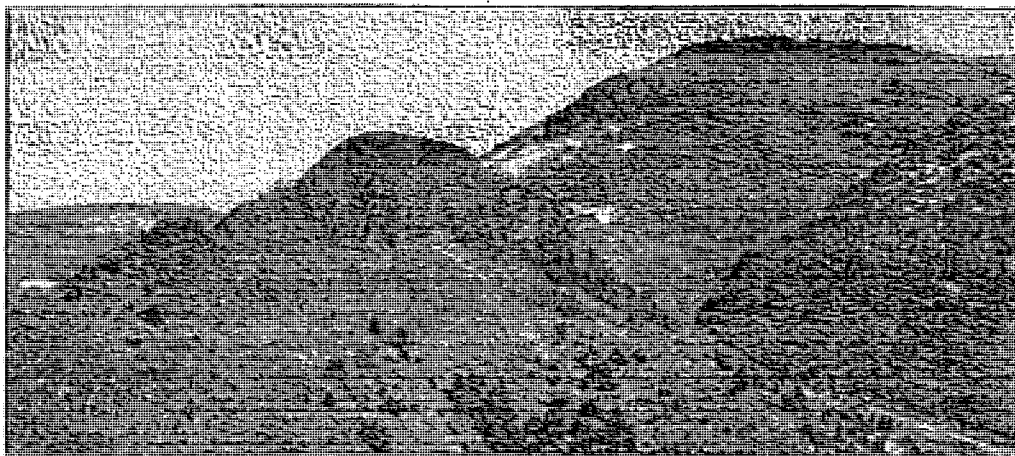
²⁷² Various Documents HCEII, Notes from conversation between Tom Chace and Arlene Johnson, Feb. 10, 2010, Page 106

²⁷³ Keith Emmer's Emails, Lindsay Atwood to Keith Emmer, October 23, 2009, Page 136

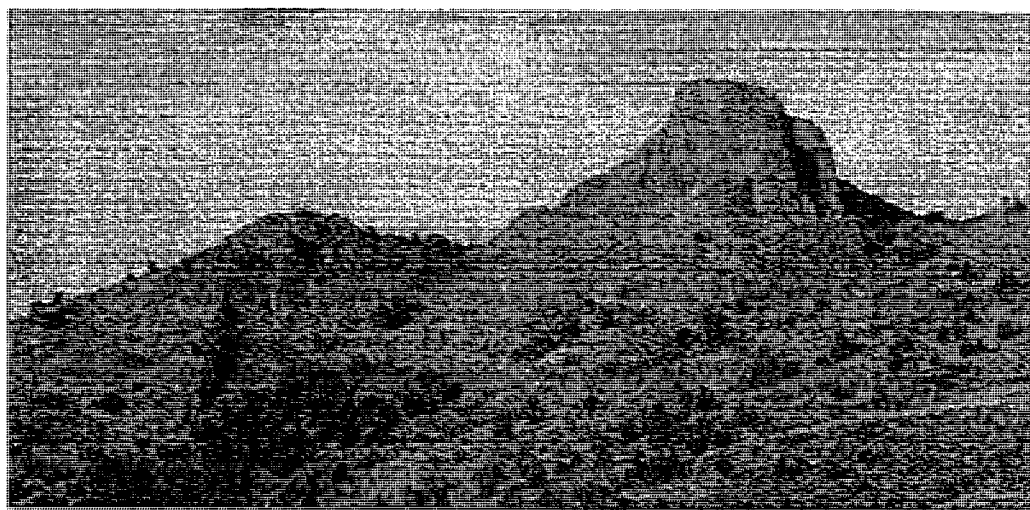
²⁷⁴ Keith Emmer's Emails, Lindsay Atwood from Keith Emmer, October 23, 2009, Page 136

²⁷⁵ Keith Emmer's Emails, Lindsay Atwood to Keith Emmer, October 24, 2009, Page 137

XI. Photographs



1. Plaintiffs' Property from the West. Steep section of Step Mountain Road where it bisects Lindsay Atwood's Property. Photo by SLC



2. Step Mountain, from the Southwest, Photo by SLC



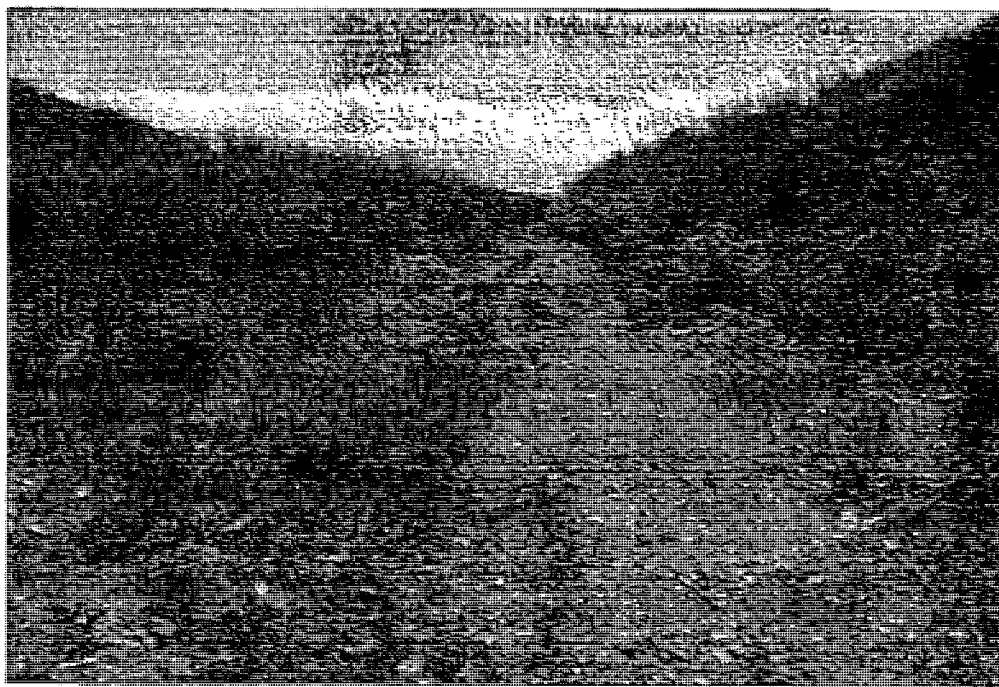
3. Frontage of lot 100 on Step Mountain Road looking northwesterly toward the top of Step Mountain. 4/25/10. Photo by SLC



4. Lot 99 looking Northwesterly before Road drops in elevation. A small part of road is visible on the left. Top of Step Mountain at the Center. 11/5/06. Photo by Arlene Johnson



5. Step Mountain Road 1992-1993. Road had been graded for delivery and installation of water pipe. Photo by Plaintiffs included in complaint.



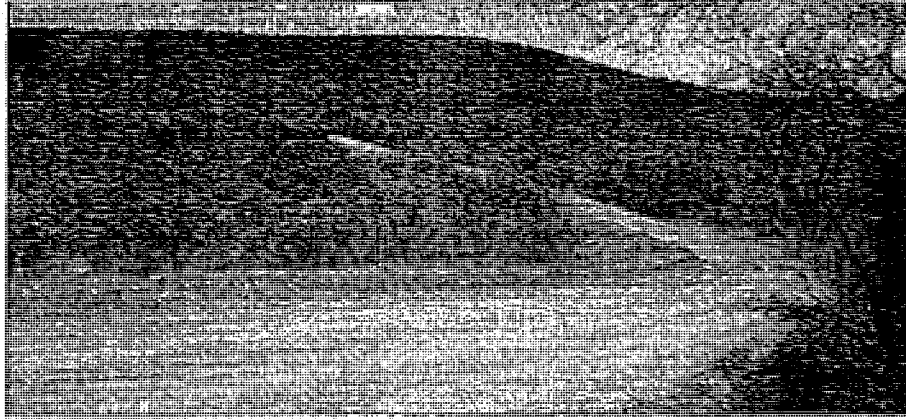
6. Step Mountain Road from Lot 100 frontage looking south 4/25/10. Photo by SLC.



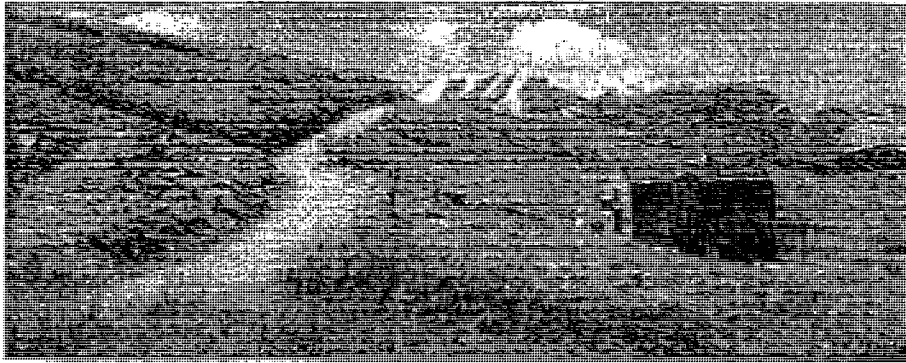
7. Step Mountain Road Fall 2009. Photo by Plaintiffs included in complaint.



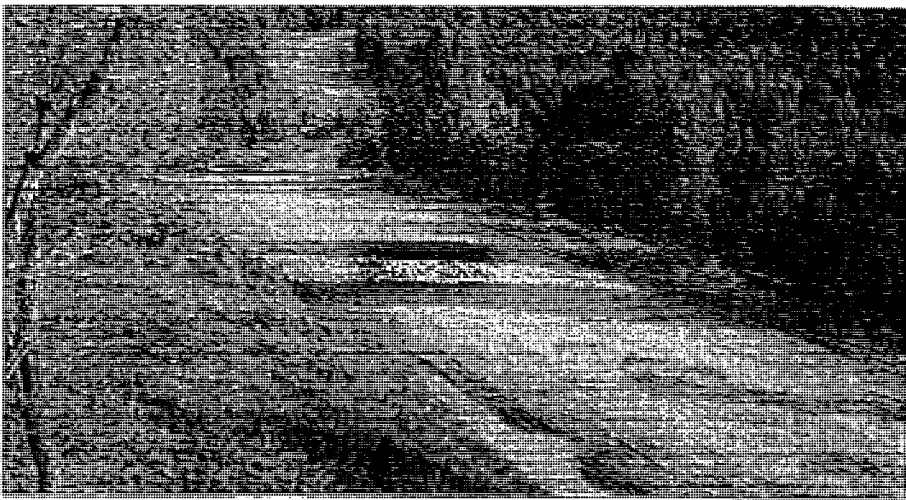
8. Step Mountain Road at well house. 11/28/09 Photo by Keith Emmer.



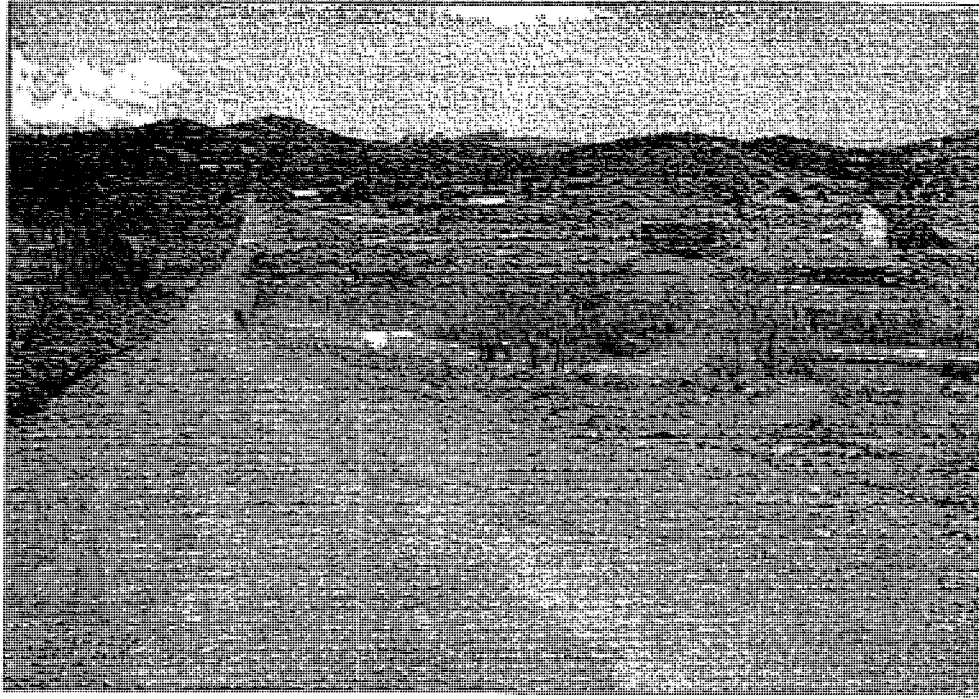
9. Brandon Frank's frontage, Lots 112 and 122C on Step Mountain Road, 4/25/10 Photo by SLC



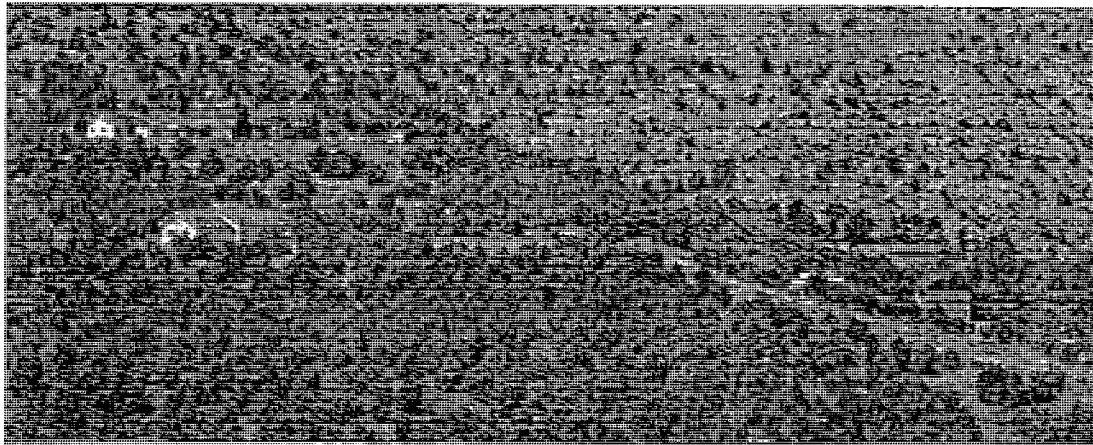
10. Carol Dean's Frontage on Step Mountain Road, 4/25/10 Photo by SLC



11. Arlene Johnson's frontage on Shaggy Mountain Road, 4/15/10 Photo by SLC



12. Keith Emmer's and Tom William's frontage, 14900 S looking west. 4/24/10 Photo by SLC.



13. Tony Sarra's house upper left. Paved portion of Mountain Top Road extends from the square to a point beyond the right edge of the photograph. 4/24/10 Photo by SLC (Closer views of the asphalt are contained in the claim)

XII. Bibliography

Certificate of Incorporation of Hi-Country Estates Homeowners Association

Protective Covenants, Hi Country Estates Homeowners Association Phase II

Bylaws of Hi Country Estates Homeowners Association Phase II, Inc.

Hi-Country Estates II Architectural Control Committee Policies and Procedures Manual

Various Documents, Hi Country Estates Homeowners Association Phase II

Keith Emmer's Emails, Hi Country Estates Homeowners Association Phase II

Documentation for the ACC, Hi Country Estates Homeowners Association Phase II

Special Litigation Committee Interviews, March 2010

Special Litigation Interviews, Plaintiffs

Map, Status of HCEII Roads

Map, Land Qualified for Greenbelt

Map, HCEII Non-buildable Land Area

HI-COUNTRY ESTATES PHASE II

DECEMBER 2009

Legend:

- Survey boundary
- Survey boundary (proposed)
- Survey boundary (proposed)
- Survey boundary (proposed)

NORTH

HI-COUNTRY ESTATES PHASE II

DECEMBER 2009

Legend:

- New Survey to Public Land
- New Survey to Private Land
- New Survey to Private Land
- New Survey to Private Land
- New Survey to Private Land

North Arrow

HI-COUNTRY ESTATES PHASE II

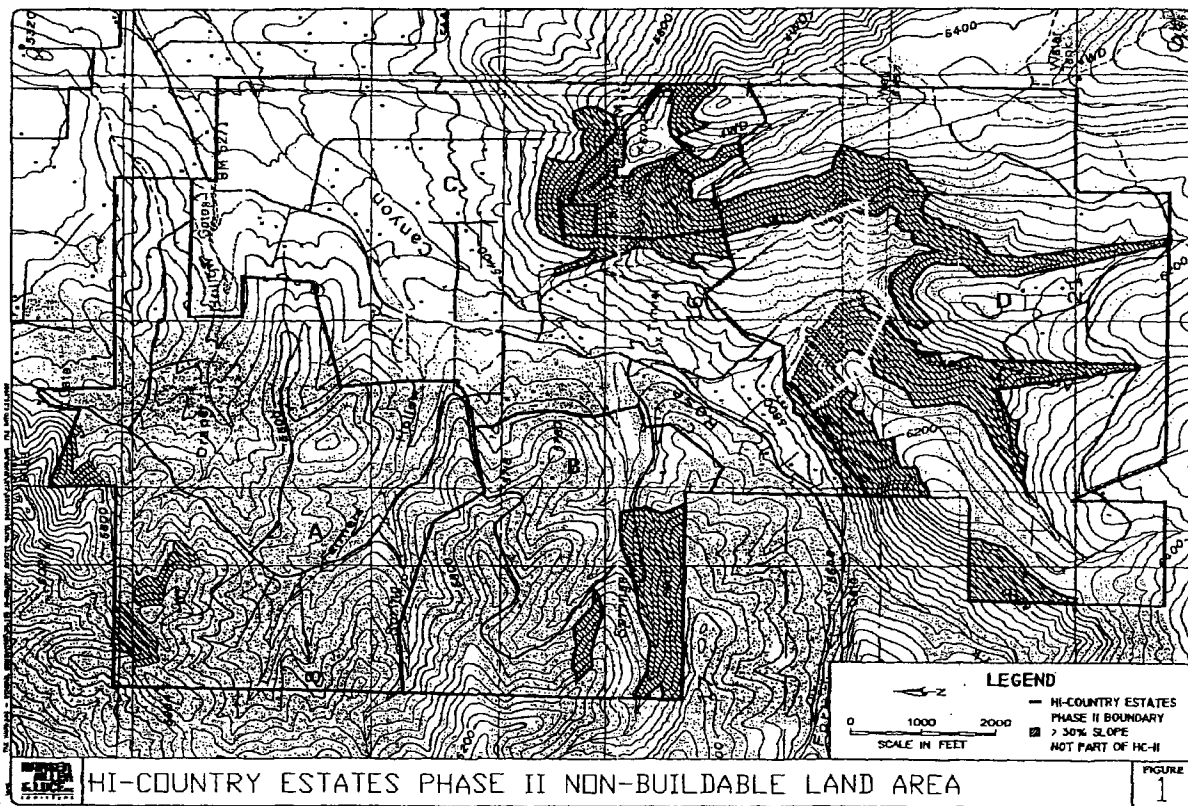
DECEMBER 2009

Legend:

- New Survey to Public Land
- New Survey to Private Land
- New Survey to Private Land
- New Survey to Private Land
- New Survey to Private Land

North Arrow

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HCED0135

