IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

IN RE THE DOW CHEMICAL COMPANY DERIVATIVE LITIGATION,	)	CONSOLIDATED C.A. No. 4349-CC

PLAINTIFFS' OPPOSITION TO DEFENDANTS' MOTION TO DISMISS

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Plaintiffs Michael D. Blum and Norman Meier ("Plaintiffs") respectfully submit this memorandum of law in opposition to the motion of defendants The Dow Chemical Company ("Dow"), Andrew N. Liveris, Geoffrey E. Merszei, Arnold A. Allemang, Jacqueline K. Barton, James A. Bell, Jeff M. Fettig, Barbara Hackman Franklin, John B. Hess, Dennis H. Reilley, James M. Ringler, Ruth G. Shaw, Paul G. Stern, Michael Gambrell, William Banholzer, and David E. Keplerto ("Defendants") dismiss the Complaint ("Compl.").

PRELIMINARY STATEMENT

In December 2007, at the conclusion of a weeklong visit to Kuwait, Dow's Board of Directors caused the Company to enter into a Memorandum of Understanding ("MOU") with that nation's Petrochemicals Industries Company ("PIC"). The MOU provided for $9.5 billion in cash payments to Dow upon the transfer of certain commodities chemicals businesses into a joint venture (known as "K-Dow") with Kuwait. According to some members of Kuwait's supreme legislative body, the National Assembly, the K-Dow venture was procured by the payment of bribes to Kuwaiti oil officials by unidentified representatives of Dow.[1]

Six months after signing the deal with Kuwait, which contained multiple conditions and was not binding on either party, the Dow Board unanimously caused Dow to enter into a transaction to acquire all of the stock of specialty chemical maker Rohm & Haas ("R&H") for $19 billion (the "R&H Merger"). Although Dow management (with the acquiescence of the Board) denied that the $9.5 billion K-Dow proceeds were essential to paying for the R&H shares, later events show that this was untrue, and that Dow management and the Board indisputably

[1] Earlier that same year, officers of a Dow subsidiary were alleged by the SEC to have paid bribes to government officials in India to secure the marketing of three insecticides in that country, and Dow later agreed to pay a $325,000 civil penalty to settle those charges.

knew that it was untrue. The $9.5 billion was essential to funding this huge acquisition. The reason for this subterfuge was to cover up the Board's reckless "bet the Company" gamble. Indeed, if the K-Dow deal did not close (and its consummation was far from certain), Dow would be brought to its knees financially.

Unlike the K-Dow deal, the R&H Merger was airtight; it contained no conditions or "out" clauses that would allow Dow to escape the deal, and it provided for severe penalties, including the right of R&H to specifically enforce the transaction and impose substantial monetary penalties, should Dow attempt to back out of it. As noted, Dow's ability to consummate the R&H Merger, from the start, was financially dependent on the closing of K-Dow and the receipt of $9.5 billion from Kuwait. In later litigation with R&H, Dow was forced to judicially admit this dependency. Despite this dependency, at and after the announcement of the R&H Merger, Dow's top officers and Board members, including Andrew Liveris and Geoffrey Merszei, with the knowledge and approval of the other Board members, publicly and falsely assured shareholders that the Merger was not dependent at all on K-Dow. The Board members knew the disturbing truth; public shareholders did not.

Before either K-Dow or the R&H Merger could close, the National Assembly began investigating allegations of the payment of bribes, fearing the repercussions from the economic downturn and generally having second thoughts about the K-Dow deal. Citing economic uncertainty as its reason for cancellation, Kuwait unilaterally rescinded the K-Dow deal (as it had the right to do under its non-binding agreement), leaving Dow with a $9.5 billion cash deficit and unable to consummate the R&H Merger pursuant to the merger terms without risking financial ruin. A lawsuit by R&H for specific performance ensued, which exposed Dow to billions of dollars in damages and other financial repercussions, as well as reputational damage. Eventually, all parties reached an economic resolution whereby R&H was acquired, a result which caused Dow to suffer substantial monetary harm. This shareholder derivative proceeding, brought on behalf of Dow by two of its shareholders, seeks to hold the Board of Directors accountable for the breaches of fiduciary duty and other misconduct that has exposed Dow to such enormous losses.

Defendants—officers and directors of Dow—have moved to dismiss the allegations, largely on the basis that Plaintiffs did not first make demand on the Board of Directors itself to bring these claims. Significantly, except for Plaintiffs' claim for contribution and indemnification (Count III of the Complaint), Defendants do not challenge Plaintiffs' claims for failure to state a claim under Rule 12(b)(6). Rather, Defendants' motion is based virtually entirely on failure to make pre-suit demand under Rule 23.1. Defendants' argument boils down to the assertion that Plaintiffs have not credibly alleged, with particularized facts, that the Board's decisions were not the product of a valid business judgment—or that the Board's actions do not otherwise give rise to a substantial likelihood of liability for failure to conduct adequate oversight of Dow's officers and employees.

Defendants are wrong. At this early stage in the litigation, Plaintiffs have alleged sufficient particularized facts to indicate that Dow's Board of Directors did not carry out their fiduciary duties in good faith, did not exercise valid business judgment, and/or are liable for failure to exercise adequate oversight. From the moment it was announced, the Board actively represented the R&H Merger to Dow shareholders as not depending in any way on financing from the shaky K-Dow deal. On July 10, 2008, Board Chairman Liveris, speaking with the approval of the entire Board at a press conference dedicated to the R&H Merger, in response to a direct question, flatly denied the financial interdependence of the two deals, falsely stating, "[N]o, we are not counting on [K-Dow]. We can do this deal without the Kuwait money, and we will still stay at investment grade." (¶ 57.) "Certainly not," added Merszei, responding to the same question. (*Id.*) The Board repeated similar false reassurances to shareholders throughout the fall of 2008. (¶¶ 58-63.) In addition, the Board had the primary responsibility, when it came time to do the R&H Merger (which was a "bet the Company" transaction if ever there was one)—to conduct adequate due diligence and to prevent Dow from exposing itself to financial ruin from that ironclad, $19 billion cash commitment. Yet the Board approved the R&H Merger knowing that no sure financing had been obtained for a potentially ruinous acquisition that allowed for no exit.

In fact, as Dow ultimately admitted, when the Board approved the R&H Merger in July 2008, Dow was unable to consummate the merger, and would remain unable to do so, absent the $9.5 billion to be received from K-Dow. A Board member exercising her duty to stay informed would have known that Dow was committing itself absolutely to purchase R&H when the deal depended on cash from a nonbinding deal with an Arab emirate known for its unpredictability in business dealings. Such a Board member in the conscious discharge of her duties also was required to prevent fellow Board members Liveris and Merszei from falsely telling shareholders the exact opposite of the truth, *viz.*, that the R&H merger did not depend in any way on K-Dow. A diligent Board member, knowing of Dow's recent payment of a civil penalty in connection with charges of bribery of foreign officials to achieve business ends, would have been particularly alert to any impropriety or irrationality in a major business deal with the sovereign state of Kuwait, known for its unpredictability and corruption. Yet, as alleged in the Complaint, no member of the Board of Directors was faithful to Dow in this way.

In addition to the above, which amounts to a conscious dereliction of duty, Dow's 12-person Board also is unable to objectively consider a demand because it is structurally compromised. Three Board members—Liveris, Allemang, and Merszei—are longtime corporate insiders who depend for their livelihood on their positions at Dow. Liveris simultaneously holds at least four of the major executive positions at Dow. Seven directors—Reilley, Stern, Fettig, Franklin, Bell, Hess, and Shaw—are beholden to Liveris and/or to other Board members sufficiently to compromise their judgment and prevent them from objectively considering a demand to investigate or bring the claims in this lawsuit.

The motion to dismiss should be denied, and these claims should be allowed to proceed without the futile gesture of first making demand on Dow's interested and nonindependent Board.

FACTUAL ALLEGATIONS

In December 2007, the entire Board of Directors traveled to Kuwait to sign a memorandum of understanding ("MOU") with that country's state-run Petrochemical Industries Company ("PIC"). The contemplated transaction came to be known as the "K-Dow" venture. Compl. ¶ 47. Through K-Dow, in exchange for conveying a 50-percent interest in certain of its commodities chemicals businesses to PIC, Dow could receive some $9.5 billion in cash. *Id.*. ¶¶ 5, 47, 48. The deal was set to close in December 2008. *Id.* According to several members of the Kuwaiti National Assembly (that country's supreme legislative body), which commenced an investigation into the transaction, the K-Dow deal was procured through the payment of bribes to Kuwaiti state oil officials by unidentified Dow representatives. *Id.* ¶ 16, 77-79.[2]

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[2] The National Assembly's accusations marked the second time in only two years that Dow executives were charged with bribery of foreign officials to achieve key business objectives. In January 2007, officers of Dow's Indian subsidiary paid over $200,000 in bribes to Indian government officials to achieve expedited registration of three pesticides for sale in that country. *Id.* ¶ 20. In 2007, Dow paid a $325,000 fine to the United States Securities and Exchange Commission ("SEC"). *Id.* Dow's Board of Directors—including the members of its Audit Committee, who were specifically charged with ensuring that the Company's business units

The K-Dow transaction was critical to Dow and lay at the core of its transformational strategy to shift from commodities chemicals to more profitable specialty chemicals. Compl. ¶ 2, 3, 43, 44, 46. Counting on $9.5 billion in proceeds from K-Dow deal, the Board of Directors subsequently voted, unanimously, to commit Dow to a transaction to acquire all of the stock of specialty chemicals maker Rohm & Hass ("R&H") for $19 billion in cash. *Id.* ¶ 6, 9, 46, 52, 131. The R&H Merger involved the payment to shareholders of R&H of $78.00 per share in cash—an astonishing 75 percent premium over the existing share price. *Id.* ¶ 52.

The acquisition of R&H, referred to as the "R&H Merger," was signed in July 2008 and, like K-Dow, was expected to close in late December 2008 or early January 2009. *Id.* ¶¶ 9, 13, 52, 57. Various Dow defendants such as Andrew Liveris and Geoffrey Merszei—with the knowledge and approval of the entire Dow Board—assured shareholders throughout the latter half of 2008 that closing the $19 billion cash deal for R&H ***did not depend in any way*** on receiving the $9.5 billion in cash from K-Dow. *Id.* ¶¶ 57-63. The truth was otherwise. Indeed, when it was unable to close the R&H Merger as promised and was in turn sued by R&H, the Board had no choice but to cause Dow to ***judicially admit***, in its Answer to the R&H complaint, that cash receipts from the K-Dow deal were, ***all along, to be the primary component*** of financing through which Dow could complete the R&H Merger. *Id.* ¶¶ 15, 88, 89.

Once the National Assembly began its investigation of the possible bribes of Kuwaiti state oil officials and some Kuwaiti officials determined the economic environment to be too volatile to complete the deal, Kuwait's Supreme Petroleum Council ("SPC") unilaterally rescinded the K-Dow deal. Compl. ¶¶ 14, 76-79. This occurred on December 28, 2008. *Id.* 76. Regardless of

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throughout the world were in conformity with all applicable legal and internal ethical requirements—could not have been unaware of this episode, or its repercussions for Dow's ongoing operations and reputation. *Id.* ¶¶ 20, 22, 129.

whether any such bribery truly occurred, or whether Kuwait truly had the right to cancel the deal due to purely economic terms, Dow's Board knew from the inception of the K-Dow venture that Dow was relying on an unpredictable regime whose adherence to the rule of law was doubtful, and which had negotiated a loose contract that could easily be terminated with no real repercussions for Kuwait. Kuwait's political situation is highly unstable. Endemic infighting between the National Assembly and Cabinet have, since the 1990s, delayed a proposed $8.5 billion project to boost output from Kuwait's northern oilfields with the help of Western companies. Despite these clear "red flags," however, the Board approved a sales agreement to Kuwait that was, in sum and substance, an illusory contract. ¶¶ 47-50. The agreement effectively allowed Kuwait to delay or cancel the deal for any reason, or for no reason. Delay was even stipulated as a grounds which would completely excuse performance. Indeed, according to the Board's press release announcing K-Dow: "The [joint venture agreement] contains certain termination rights for both the Company and PIC, including the right of either party to terminate if the Closing has not occurred by the sixth month anniversary of the date of the execution of the JVFA, subject to an extension for another six months if certain regulatory clearances are not obtained prior to such extension." *Id.* ¶¶ 49-50. Remedies for a breach by either party were expressly limited to monetary damages not exceeding $2.5 billion—relief which the Dow Board knew could never be collected from Kuwait in any legal battle, and which was patently inadequate in light of the dependency of the $19 billion R&H Merger on $9.5 billion to be received from Kuwait. *Id.*[3]

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[3] The Board's press release continued: "Further, the JVFA provides that upon termination of the agreement due to either a failure by a party to perform its obligations or a failure to consummate

Despite the further "red flag" that (as Dow later admitted) financing for the R&H acquisition was dependent primarily on the illusory contract with Kuwait, Dow's Board of Directors then administered the near-fatal blow, in conscious disregard of its duty to prudently manage the Company. The Board unanimously approved the ironclad Merger Agreement with R&H that committed Dow unconditionally to the $19 billion purchase. The Board caused Dow to bind itself to the R&H Merger with no financing conditions or any other ability to postpone or cancel that deal should Dow be unable to raise the $9.5 billion from K-Dow. Compl. ¶¶ 9, 12, 19, 20, 21, 57, 64-67, 93, 94, 98. For example, the Board caused Dow to guarantee that it would obtain the financing necessary to obtain the deal, covenanting that it "shall take all action necessary to ensure that as of the Closing Date, [Dow] will obtain the Financing." *Id.* ¶ 65. The Board further covenanted, in Section 4.6 of the Merger Agreement, that Dow "will have available to it at the Closing all of the funds required to be provided by [Dow] for the consummation of the transactions contemplated hereby . . . ." *Id.* ¶ 66. In addition, the Agreement provided that Dow would assume all risks of negative developments affecting the chemical industry or financial markets—through an unusually restrictive definition of "Material Adverse Effect." *Id.* ¶ 68. The inescapability that Dow must write a check to R&H for $19 billion—coupled with the Company's admitted dependence on K-Dow for the principal part of those funds—meant that the Board of Directors ***bet the Company's entire future on a non-binding, essentially illusory agreement with an emirate notorious for scuttling commitments at whim***.

The rescission of K-Dow, which had been set to close on January 2, 2009, Compl. ¶ 74, put Dow in an impossible situation. The closing of the R&H Merger—which depended for fully

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the Closing pursuant to the JVFA, the maximum amount of damages which can be claimed by either party is $2.5 billion."

one-half of its funding ($9.5 billion) from the proceeds of K-Dow—was itself set for January 12, 2009, only ten days later. *Id.* ¶ 73. As noted above, Dow's Board of Directors had committed the Company to an unconditional, ironclad closing. *Id.* ¶¶ 9, 12, 19, 20, 21, 57, 64-67, 93, 94, 98. In addition, the Board had caused Dow to subject itself to a suit for specific performance of the R&H Merger, and had even exposed Dow to severe penalties (including a $3.3 million "ticking fee" per day) should the R&H Merger not close for any reason. *Id.* ¶ 69-72.

When Kuwait canceled K-Dow, in the circumstances of Dow's ironclad deal with R&H, the consequences played out like a theatrical tragedy, with predictably disastrous results for Dow. Unable to close the R&H Merger on time, Dow's Board of Directors purposefully delayed the closing. Compl. ¶¶ 14, 81-85. At one point, members of the Board of Directors even visited Washington to lobby the Federal Trade Commission for a delay in issuing antitrust approval for their own deal, and when that gambit failed, the Board thereafter simply refused outright to close the R&H Merger. *Id.* ¶¶ 81-85. Finally, R&H sued Dow in this Court to specifically enforce the terms of the merger. *Id.* ¶ 86. Had the merger been enforced,[4] defendant Liveris stated, Dow would have "risk[ed] financial ruin"—by paying billions of dollars in cash it did not have, either to consummate the R&H Merger or to satisfy a damages award. *Id.* ¶¶ 17, 92, 100. The repercussions would also have included tens—if not hundreds—of millions of dollars in contractually-stipulated "ticking fees" (*id.* ¶¶ 18, 99), loss of Kuwaiti business (*id.* ¶ 102), dramatically increased costs of capital through ratings downgrades (*id.* ¶ 103-104), declines in market capitalization (*id.* ¶ 106), probable insolvency (*id.* ¶ 17), and massive reputational harm

[4] The R&H lawsuit was settled on the very day set for trial, with certain R&H shareholders agreeing to delay the closing and take a preferred equity stake in Dow, thus freeing $2.5 billion in cash to complete the R&H Merger.

(¶¶ 1, 95, 104, 105).[5]

ARGUMENT

I. THE LEGAL STANDARDS FOR DECIDING DEFENDANTS' MOTION

A. Chancery Court Rule 23.1

The plaintiff in a shareholders' derivative action must allege either: (a) that he or she has made a demand on the corporation's board of directors to take the requested action; or (b) the reasons for not making demand, i.e., the reasons why demand is futile. Fed. R. Civ. P. 23.1. Such futility is apparent where a majority of the Board either lacks independence or is not disinterested. *See Rales v. Blasband*, 634 A.2d 927, 932 (Del. 1993); *Saito v. McCall*, No. 17132, 2004 Del. Ch. LEXIS 205, at *33 n.68 (Del. Ch. Dec. 20, 2004).

Pleading demand futility, however, is not nearly as difficult as Defendants insist. There is no requirement that plaintiff plead evidence. *Levine v. Smith*, 591 A.2d 194, 207 (Del. 1991); *Aronson v. Lewis*, 473 A.2d 805, 816 (Del. 1984), *overruled in part on other grounds, Brehm v. Eisner*, 746 A.2d 244 (Del. 2000). Instead, the complaint need only raise a "reasonable doubt" as to the disinterestedness or independence of a majority of directors. *Aronson*, 473 A.2d at 814.[6]

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[5] Moreover, even with the settlement of the R&H lawsuit, Dow is still left with hundreds of millions, if not billions, of dollars in potential liabilities and damages, including: (a) $200 million in "ticking fees"; (b) hundreds of millions of dollars in interest on the $7 billion in financing to fund the merger that was not replaced by the R&H shareholders' $2.5 billion cash infusion; (c) $156 million in additional "structuring fees" imposed by Dow's banks in the revised bridge loan facility necessary to complete the merger; (d) the amount by which the present value of 15 percent dividends in perpetuity to be paid to the new preferred shareholders exceeds the $2.5 billion cash infusion provided by them; and (e) the amount by which the profit achieved on the sale of a 50-percent interest in the plastics business will have declined from the December 31, 2008 targeted date for the closing of K-Dow, to the actual date of sale.

[6] "Reasonable doubt can be said to mean that there is a *reason to doubt.* This concept is sufficiently flexible and workable to provide the stockholder with the 'keys to the courthouse' in

Similarly, the plaintiff is not required to plead facts sufficient to sustain a judicial "finding." *In re Walt Disney Co. Deriv. Litig.*, 825 A.2d 275, 289 (Del. Ch. 2003); *Grobow v. Perot*, 539 A.2d 180, 186, 195 (Del. 1988). Nor must plaintiff demonstrate a reasonable probability of success on the merits. Instead, plaintiffs need only make a "threshold showing, through the allegation of particular facts, that their claims have some merit." *Rales*, 634 A.2d at 934 (citing *Aronson*, 473 A.2d at 811-12).

In conducting this analysis, the Court must review the Complaint in its entirety, must assume the truth of the allegations, and must draw all reasonable inferences in favor of Plaintiffs. *Rales*, 634 A.2d at 931; *Wood v. Baum*, 953 A.2d 136, 140 (Del. 2008); *Beam v. Stewart*, 833 A.2d 961, 1048 (Del. Ch. 2003). Rather than dissecting the Complaint into component parts, the Court must ***read all of Plaintiffs' allegations as a whole***, not relying on any one factor but examining the totality of the circumstances. *Harris v. Carter*, 582 A.2d 222, 229 (Del. Ch. 1990); *Friedman v. Beningson*, No. 112232, 1995 Del. Ch. LEXIS 154, at *12 (Del. Ch. Dec. 4, 1995).

B. Demand Futility Under *Aronson* and *Rales*

Under Delaware law, the leading case for determining whether demand is futile with respect to an affirmative action of the Board—or a decision not to take *any* action—is *Aronson*. A plaintiff is excused from making a pre-suit demand on a Board if there is reason to doubt that: (i) a majority of its directors are independent or disinterested; ***or*** (ii) the challenged acts are a valid exercise of business judgment. *See Aronson*, 473 A.2d at 812.

Regarding the first prong of *Aronson*, two kinds of allegations allow a court to infer a

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an appropriate case where the claim is not based on mere suspicions or stated in conclusory terms." *Grimes v. Donald*, 673 A.2d 1207, 1217 (Del. 1996) (emphasis added), *overruled in part on other grounds*, *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).

reasonable doubt. First, "[d]irectorial interest exists whenever divided loyalties are present, or a director has received . . . a personal financial benefit from the challenged transaction . . . not equally shared by the stockholders." *Pogostin v. Rice*, 480 A.2d 619, 624 (Del. 1984). Second, reasonable doubt is raised where the allegations show that a director, though disinterested in the transaction, is under the influence of interested directors. *Seminaris v. Landa*, 662 A.2d 1350, 1354 (Del. Ch. 1995).

To implicate the second prong of *Aronson*, a plaintiff must challenge a board decision where its members exercised business judgment. *Id.* at 812. In the alternative, the test may be satisfied by pleading a "conscious decision ***to refrain*** from acting." *Aronson*, 473 A.2d at 813 (emphasis added); *Rales*, 634 A.2d at 933.

For example, in *Disney*, the court found that the directors were alleged to have adopted an "ostrich-like approach" to whether the company should enter into a lavish employment agreement with Michael Ovitz whereby Mr. Ovitz would receive $38 million in cash upon termination for any reason. *See Disney*, 825 A.2d at 289. The court further found that the Board allegedly knew and approved of the agreement but never sought to negotiate the amounts with Mr. Ovitz, thus raising a substantial likelihood of liability for violation of the duty of good faith and excusing demand:

> These facts, if true, do more than portray directors who, in a negligent or grossly negligent manner, merely failed to inform themselves or to deliberate adequately about an issue of material importance to the corporation. Instead, the facts alleged in the new complaint suggest that the defendant directors *consciously and intentionally disregarded their responsibilities*, adopting a "we don't care about risks" attitude concerning a material corporate decision. *Knowing or deliberate indifference by a director to his or her duty to act faithfully and with appropriate care is conduct . . . that may not have been taken honestly and in good faith to advance the best interests of the company.* Put differently, all of the alleged facts, if true, imply that the defendant directors *knew* that they were making material

> decisions without adequate information and without adequate deliberation, and that they simply did not care if the decisions caused the corporation and its stockholders to suffer injury or loss.

Id. (second emphasis added). The *Disney* court went on to identify the following examples of conduct that would establish a failure to act in good faith, thereby excusing demand:

> A failure to act in good faith may be shown, for instance, where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable law, *or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties.*

Id. at 67.

When the challenged misconduct does not constitute a business decision by the Board, however, *Rales* applies. *Rales* addresses demand futility when the wrongdoing arose out of ***unconscious*** inaction—for example, failure to oversee subordinates or have a system of control procedures. *In re Caremark Int'l Deriv. Litig.*, 698 A.2d 959, 971 (Del. Ch. 1996) ("ignorance of liability creating activities"). Under *Rales*, courts evaluate whether the allegations create "a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand." 634 A.2d at 934.

The *Rales* test, like *Aronson*, also focuses on likelihood of liability for the wrongs complained of. Thus, "[d]irectors who are sued for failure to oversee subordinates have a disabling interest [for pre-suit demand purposes] when the potential for liability is not a 'mere threat' but instead may rise to a 'substantial likelihood.'" *In re Baxter Int'l S'holders Litig.*, 654 A.2d 1268, 1269 (Del. Ch. 1995) (quoting *Rales*, 634 A.2d at 936); *Caremark*, 698 A.2d at 969.

C. Ways of Pleading Demand Futility

Based on the above case law, with respect to any one director or group of directors, there are many different ways of pleading demand futility. If a business decision of the Board is involved, futility can be pleaded one of three ways: (1) by alleging that the director is not disinterested in the decision because he or she received a personal financial benefit; (2) by alleging that the director is not independent of other directors or the company; ***or*** (3) by alleging that the decision was not the valid product of business judgment. If Board ***inaction*** is involved, futility can be pleaded by: (4) alleging that the director faces a substantial likelihood of liability for failing to exercise oversight over the persons who engaged in the misconduct at issue.

II. THE COMPLAINT ADEQUATELY PLEADS DEMAND FUTILITY AS TO AT LEAST SIX DIRECTORS

At the time the Complaint was filed, Dow's Board consisted of 12 directors: Liveris, Merszei, Allemang, Barton, Bell, Fettig, Franklin, Hess, Reilley, Ringler, Shaw, and Stern. As Defendants concede, Plaintiffs need only raise a reasonable doubt as to the independence or disinterestedness of ***six*** of these directors. Compl. ¶ 125; Def Mem. at 14. The Complaint amply satisfies this requirement.

A. Three Directors—Liveris, Merszei, and Allemang—are Corporate Insiders Who Depend for their Livelihood on Dow

Liveris, Merszei, and Allemang are corporate insiders who are officers and employees of Dow and who depend for their livelihood on the salary and other compensation they receive from the Company. Compl. ¶¶ 23, 24, 34. Among other things, Liveris received $18.2 million in compensation in 2007 and serves simultaneously as President, Chief Executive Officer, Chief Operating Officer, Chairman of the Board of Directors, and Chairman of the Executive Committee. *Id.* ¶ 23. Merszei, who received $8.8 million, is the Chief Financial Officer and a member of the Executive Committee. Allemang has been an officer or other employee of Dow for some 43 years. *Id.* ¶ 34. Importantly, all three of these directors are acknowledged by Dow to be not independent under either the listing standards of the New York Stock Exchange or the Company's own Director Independence Standards. *Id.* ¶ 42(c). Particularized allegations such as these are sufficient to raise a reasonable doubt regarding such directors' independence and their ability to objectively consider a pre-suit demand. *See Rales*, 634 A.2d at 937 (finding reasonable doubt regarding independence when officer's annual compensation was $300,000; "there is a reasonable doubt that [an employee-d(irector] can be expected to act independently considering his substantial financial stake in maintaining his current offices").[7] Liveris is further compromised by his membership on the Board of Citigroup, Inc., which controls $13 billion in financing to Dow to fund the R&H Merger; this puts Liveris effectively on both sides of the financing relationship giving rise to a conflict of interest. (Compl. ¶ 125(f).)

B. The Other Eleven Directors are not Independent of Liveris or one Another

As alleged in the Complaint, the Dow Board exhibits substantial defects in structural independence that compromise the independence of the Board members from Chairman Liveris and from one another. First and foremost, the entire Board is dominated and controlled by Chairman Liveris. This is established by the Complaint's particularized allegations that the Board has allowed Liveris to assume an autocratic and abnormal role as the combined Chairman, Chief Executive Officer, President, and de facto Chief Operating Officer of the Company, thus allowing him to control the compensation and benefits paid to the other directors, what

[7] *See also In re The Limited, Inc. S'holders Litig.*, No. 17148, 2002 Del. Ch. LEXIS 28, at *20-*22 (Del. Ch. Mar. 27, 2002) (receipt of $1.8 million in compensation was sufficient to call director's independence into question); *In re Cooper Cos. S'holders Deriv. Litig.*, No. C.A. 12584, 2000 Del. Ch. LEXIS 158, at *19-*20 (Del. Ch. Oct. 31, 2000); *Mizel v. Connelly*, No. 16638, 1999 Del. Ch. LEXIS 157, at *8 (July 22, 1999); *Steiner v. Meyerson*, No. 13139, 1995 Del. Ch. LEXIS 95, at *29 (Del. Ch. July 18, 1995); *Telxon Corp. v. Bogomolny*, 792 A.2d 964, 974 (Del. Ch. 2001), *rehearing denied*, 2001 Del. Ch. LEXIS 148 (Dec. 16, 2001); *In re Ply Gem Indus. S'holder Litig.*, No. 15779, 2001 Del. Ch. LEXIS 84, at *28-*29 (June 26, 2001).

committees they sit on, and what role they play in governance—and, thus, to dominate their ***decisions***. (Compl. ¶¶ 125(a).) There is abundant evidence of such control. In early 2007, around the same time that the Board knowingly caused Dow to settle charges of bribery of Indian officials and pay a fine to the SEC, Liveris ordered the Board, ***overnight***, to summarily terminate two dissident officers, Romeo Kreinberg and J. Pedro Reinhard, who had urged a long-term strategy upon the Board which differed from Liveris's, deny them their vested equity, and desist from any efforts to review or analyze their concerns or the efforts they had made on the Company's behalf. (*Id.* ¶ 125(b).) It is unreasonable to suppose that similar influence over the other directors' decision-making process would ***not*** be exerted by Liveris over at least five Board members with respect to any request to investigate wrongdoing in connection with the R&H Merger and other transactions complained of in this lawsuit.

There are ***further*** particularized allegations of facts evidencing Liveris's domination with respect to ***seven*** other Board members. Indeed, six Board members (Bell, Hess, Merszei, Reilley, Shaw, and Stern) joined the Board in 2005 or later—after Liveris had become Chairman and CEO. (Compl. ¶ 125(d).) With respect to these six, it is reasonable to infer that Liveris hand picked or played a heavy role in their selection for and retention on the Board.[8] A seventh director (Franklin), who depends for her livelihood on representing the interests of American

[8] Thus: (a) Hess serves with Liveris on two prominent business councils, The Business Council and The National Petroleum Council (Compl. ¶ 125(j)(i)); (b) Bell depends for his livelihood on his position as the Chief Financial Officer of Boeing Company; his superior, W. James McNerney, Jr., Boeing's Chairman and CEO, sits with Liveris (and Franklin) on the US-China Business Council; thus, Bell cannot be expected to take steps against Liveris (or Franklin) lest they disparage him to McNerney, his boss at Boeing and their colleague on the USCBC (*id.* ¶ 125(j)(ii)); and (c) Reilley serves with Liveris on the American Chemistry Council, where Reilley, as former Chairman thereof, provides support to Liveris as current Chairman. (*Id.* 125(j)(vi).)

companies doing business in China, was recently awarded a prestigious position on the Board of the US-China Business Council (an honor that will help her career immeasurably) at the same time that Liveris became Chairman of that body, raising a reasonable inference that Liveris is in a position to, and does, exert heavy influence over her continued service at USCBC. (*Id.* ¶ 125(i).)

All seven of these Liveris directors have stepped into interlocking positions of nominal authority at Dow, forming a tight "inner circle" on the Board and thereby assuring that power emanates from, and remains centralized in, Liveris. Thus, Franklin, Bell, and Stern (joined by Fettig, who is beholden to Stern[9]) constitute the Governance Committee of Dow (*id.* ¶¶ 125(h), 135), and these four directors have simply appointed themselves to four out of the five seats on the Audit Committee (*id.* ¶¶ 125(h), 136)—an astonishing breach of protocol given that the Governance Committee, by its nature, is charged with ensuring strong, independent Board Committees with healthy checks and balances. (*Id.* ¶¶ 125(e), 135.) The fifth seat on the Audit Committee is held by Reilley, a Liveris appointee and his compatriot on the American Chemistry Council.

The Audit Committee, charged as it was with monitoring regulatory and legal affairs at Dow, is also the Committee primarily accountable for the breaches of duty alleged herein. (*Id.* ¶ 125(g), 131.) Thus, the Board, led by Liveris, has ensured that only those directors appointed under Liveris and financially dependent on his good graces, occupy positions on the key Audit and Governance Committees, with the two directors who predated Liveris's ascension to power, Barton and Ringler, relegated to positions on the Compensation Committee.

The seven Liveris appointees' loyalty to and nonindependence from one another is only

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[9] *See infra*, second succeeding paragraph in the text.

confirmed by their relationships outside of Dow. Hess and Franklin are existing colleagues at J.P. Morgan Chase & Co, both serving in highly prominent and lucrative roles at that renowned investment bank. (Compl. ¶ 125(j)(iii).) Neither would take action to investigate or sue the other with respect to the R&H Merger for fear of jeopardizing his own financial dependence on J.P. Morgan when his own complicity in the wrongdoing at Dow came to light. As noted previously, Bell sits on the US-China Business Council with Franklin, and is financially beholden to her as, and for the same reasons, that he is beholden to Liveris. (*Id.* ¶ 125(j)(ii).) *See supra* note 8. Stern and Hess sit together on the Council on Foreign Relations, a key policymaking and advisory body to domestic companies and government leaders. (*Id.* ¶ 125(j)(vi).) Stern and Fettig serve each other's interests at Whirlpool, where Fettig is Chairman and CEO and recruited Stern to the Board, and where Stern has sat on the nominating and corporate governance committee since 1990 and recently approved two pay packages to Fettig in 2006 and 2007 totaling over $25 million despite the fact that Whirlpool's stock price did not increase during that time and paid only modest dividends to shareholders. (*Id.* ¶ 125(j)(iv).) Stern thus has already demonstrated his loyalty to Fettig over the interests of a company on whose Board he served. Moreover, neither Fettig nor Stern would investigate or sue the other lest his own complicity at Dow lead to negative repercussions at Whirlpool (and the same is true with respect to Stern and Hess at the Council on Foreign Relations).

Defendants have no meaningful counterargument to the particularized facts alleged in the Complaint and set forth above. Where they do not simply ***ignore*** the factual allegations—or accuse Plaintiffs, seemingly with a straight face, of not setting forth "any" allegations (*see, e.g.*, Def. Mem. at 12, 24)—Defendants argue the unremarkable point that "mere outside business relationship[s], standing alone, are insufficient to raise a reasonable doubt about a director's independence." *Id.* at 24 (citing *Beam v. Stewart*, 845 A.2d 1040, 1050 (Del. 2004)). As set forth in the Complaint and explained above, it is not conclusory allegations, but rather, particularized ones concerning the nature and extent of the outside (and inside) relationships among the other Board members to Liveris (and among one another), that establish the lack of independence of Dow's Board.

C. The R&H Transaction was not the Product of Valid Business Judgment

The Compliant alleges particularized facts supporting the reasonable inference that Dow's Board of Directors acted in bad faith in unanimously approving the R&H Merger. As noted above, the Board members approved this transaction in spite of the fact that it was an ironclad deal leaving Dow with no financing or other "outs," yet was financially dependent on cash from the K-Dow to be consummated. They did so, moreover, knowing that the K-Dow deal was a ***nonbinding*** one with an emirate known for its unpredictability, corruption, and history of canceling deals without just cause. Furthermore, the Board permitted Liveris and/or Merszei to falsely claim, for months after the R&H Merger was executed, that the transaction was ***not*** dependent in any way on K-Dow. They failed to correct those misstatements despite growing indications of impending disaster. As a result of these Board members' faithlessness and conscious disregard of their obligations, when the R&H Merger collapsed, Dow was exposed to, and suffered, many tens of millions of dollars in damages.

Defendants raise only two basic arguments as to why the transactions set forth in the Complaint are, in their view, not adequately alleged to violate the business judgment rule. First, Defendants argue that Plaintiffs merely attack the "substance" of the transactions and "say nothing at all about the process" thereof. Def. Mem. at 17; *see also id.* at 16-18. This mischaracterizes the Complaint. Plaintiffs do, indeed, attack the Board of Directors for the woefully inadequate *process*, and lack of acting properly on what they must have learned through due diligence, in connection with the K-Dow and R&H transactions. The fundamental wrong complained of is that Defendants, including the Board of Directors, caused Dow to enter into an unconditional agreement to purchase R&H knowing that the transaction was financially dependent on a nonbinding deal with Kuwait, and then joining in the fraudulent concealment of this malfeasance.

The Board could not, in good faith, have: (a) let the R&H Merger Agreement be executed without any protection to Dow in case the K-Dow deal fell through; (b) let the R&H Merger be signed knowing that the Merger was financially dependent on K-Dow (as Dow later admitted); and (c) let the Merger be signed knowing that its acceptance by Dow shareholders without challenge depended upon the Board's acquiescence in Liveris's and Merszei's false denials that the deal rose or fell (as did Dow itself) on a shaky deal with an unpredictable regime. This series of events permits a reasonable inference that the Board of Directors knowingly abdicated their duty to protect Dow against the collapse of two interdependent and highly material business transactions. Liveris and Merszei also face primary liability for misstating the relationships of the two transactions to shareholders, and the Board, in allowing this misconduct to occur in light of its intimate involvement in the transactions, faces a substantial likelihood of liability for failure to prevent or correct these misstatements. *See infra*, part II.F.

Second, Defendants contend that Plaintiffs' allegations regarding Board misconduct are based merely on "hindsight," inasmuch as, "[a]t the time the directors unanimously approved the R&H transaction, there was no reason for them to believe that Dow would have difficulty closing the R&H merger." Def. Mem. at 19. But if there were no such concerns, why did Liveris and Merszei (with the Board's approval) feel a need to conceal and misrepresent the dependence of the R&H Merger on the K-Dow transaction? That act of deception allows a more than reasonable inference that Dow officials were, in fact, apprehensive about the obstacles to closing the R&H Merger, and that they had reason to believe that the Kuwait deal could run into difficulties. The Complaint, whose factual allegations the Court must take as true, pleads abundant facts constituting "red flags" that would have alerted conscientious directors that the R&H Merger faced a material risk of financial collapse. *See, e.g.*, Compl. ¶ 11, 12, 51, 52, 54, 55, 56.

D. The *Marsh & McLennan* Decision Establishes the Futility of Demand Here

Recently, Vice Chancellor Strine issued a bench ruling in *In re Marsh & McLennan Cos. Inc. Deriv. Litig.*, C.A. No. 753-VCS (Del. Ch. June 17, 2009). In that case, the Court denied a motion to dismiss for failure to plead demand futility, on alleged facts that are analogous to those here.

In *Marsh & McLennan*, plaintiff shareholders of that company ("Marsh") brought derivative claims against directors and officers for having caused or allowed Marsh, a broker which acted as an agent of entities seeking insurance, to accept lavish commissions and other special payments from insurance companies seeking lucrative insurance placements with new and existing customers. This conduct violated relevant insurance regulations, and Marsh received subpoenas from the New York Attorney General in April 2004, followed by the filing of a complaint by the Attorney General in October 2004. *Marsh* Tr. at 18.

The defendants moved to dismiss for failure to plead demand futility, arguing that the plaintiffs had not adequately pleaded deliberate or bad faith misconduct in causing the misconduct to occur, sufficient to constitute a nonexculpated claim for breach of fiduciary duty under Marsh's certificate of incorporation. *Marsh* Tr. at 16.

Vice Chancellor Strine disagreed, holding that adequate particularized facts had been pleaded that, if true, would establish conscious disregard of duties (i.e., bad faith) on the part of Marsh's directors. These included the fact that Marsh's revenues were increasingly driven by payments from insurers rather than clients (thereby giving rise to a conflict of interest at the core of Marsh's business, in the absence of any credible reason otherwise being given to the Board why this trend should be occurring), the presence of accounting policies that had been put in place to encourage Marsh's business units to engage in this practice (thereby implicating the audit committee), inadequate disclosure to clients concerning the practice, and prior warnings from insurance industry organizations against certain aspects of the practice. *Marsh* Tr. at 21-25, 27, 29-31, 46-47, 105-128.

The Court was very skeptical of the defendants' claims that the directors, merely because they were not motivated to allow illegal conduct to occur, should be held not to have allegedly consciously disregarded their duties. *Marsh* Tr. at 33. The Court held, rather, that directors were charged with exercising common sense in the context of their particular company:

> I understand. There is no motive here on the—I get that. It's why I haven't dilated on this idea that the—the independent directors consciously approved the accelerating MSA budgets in order to purposely exploit conflicts of interest—is not one that I think one can readily embrace. That is why I'm focused on *Caremark*. The fact—there is some level of duty on the part of a board to actually know the business and to actually—***it's not that difficult. Nobody should sit on a board of an insurance broker if you can't get the reality that if you are getting a lot of your funds from the insurers, rather than your clients, that you better know why***.
>
> . . . And there is a certain level beyond—there is a certain degree beyond which plaintiffs can't rationally go themselves. It's just not conceivable without full-blown discovery. You have to either bypass motions to dismiss and go to summary judgment or deal with some level of, yes, the plaintiffs don't—there is a lot that the plaintiffs don't know. And you know, you are going to have to accept what they plead is true if it's particularized.

Marsh Tr. at 36-37 (emphasis added).

After extensive argument by counsel, the Court ruled that demand was excused as futile on the facts alleged. The Court's holding is worth quoting at length:

> . . . Delaware courts, when faced with complaints like this, that allege a mixture of improper conduct and failure of oversight against directors, focus on the question that lies at the bottom of both the *Aronson* and *Rales* test, whether the plaintiffs have pled particularized facts supporting a reasonable inference that a majority of the board is subject to a nonexculpated claim for breach of fiduciary duty. That is really, at bottom, what this is about.
>
> Here, I find that the answer is yes. . . .
>
> . . . Now, here is why I find yes. And I want to emphasize that by finding yes, I will say, if I had to reveal myself and say whether I think it is likely that the plaintiffs will be able to prove that the independent directors breached their duty of loyalty, alternately, I would like to think the answer is probably no. It's not likely. ***You know, the question at this point is do they get a chance to try, access to evidence to go further.*** That is the key inquiry here. And if there is a rational inference that can be drawn from particularized facts—and there have to be particularized facts. I'm going to indicate what they are, in my view, that support a rational inference—I have to let them proceed at this point. I can't ballpark down the line what is the likely result of the case as against the independent directors. It's not the role given to the Court at this stage.

Marsh Tr. at 105-107 (emphases added).

The *Marsh & McLennan* decision has significant implications for the case at bar. First, it stands for the proposition that Boards of Directors such as Marsh & McLennan's and Dow's must exercise basic common sense in carrying out their duties. In *Marsh & McLennan*, the Court held that the doubling of Marsh's revenues from non-clients in a short period of time should have caused a conscientious Board member to ask "why"—or in the Court's formulation, "Could it be that this is coming about because we are doing things we shouldn't?" That same question should have been immediately apparent to any member of Dow's Board before agreeing to enter into a major corporate combination with R&H, at a price tag of $19 billion, based on cash to be obtained from a nonbinding deal with Kuwait. The concealment of the interdependence between K-Dow and the R&H Merger permits a strong inference that the Board members knew they were acting improperly. Second, *Marsh & McLennan* holds, in line with black letter law, that in the setting of this case, it is Plaintiffs, not Defendants, who are entitled to have reasonably contested inferences resolved in their favor—regardless of what the Court might predict to be Plaintiffs' ultimate likelihood of prevailing. Third, *Marsh & McLennan* notes that where the Board's alleged misconduct concerns issues that lie at the core of the company's business, the allegations of disregard of duties have a heightened import. (Here, of course, there could have been nothing more core or fundamental to Dow than a tenuously-financed corporate combination with a major specialty chemicals maker as part of Dow's transformational strategy.)

E. Duties of the Directors

Demand is also excused under *Rales*, as all or a majority of Dow's Board face a substantial likelihood of liability for failing, in good faith, to discharge their fiduciary duties to the Company. In this section, we examine those duties and the ways in which the Board members failed to execute them. In the next, we examine the information that was available to the Board members to enable them to carry out their duties but that was consciously disregarded by them.

As members of Dow's Committees of the Board of Directors, nine of the Director Defendants had specific oversight responsibilities for various aspects of Dow's operations, and each Committee was tasked with reporting back to the full Board. (Compl. ¶¶ 126-135.)

As members of the Audit Committee, Defendants Bell, Franklin (Chair), Fettig, Reilley, and Stern had the ultimate responsibility at the Company for the following duties, among others:

- "Discuss with management the Company's major financial risk exposures and the steps management has taken to monitor and control such exposures";
- "Obtain reports from management, the Company's senior internal auditing executive and the independent auditors concerning ***whether the Company and its subsidiary/foreign affiliated***

entities are in conformity with applicable legal requirements and the Company's Code of Business Conduct and Ethics".

- "Review reports and disclosures of insider and affiliated party transactions. Advise the Board with respect to the Company's policies and procedures ***regarding compliance with applicable laws and regulations and with the Company's Code of Business Conduct and Ethics***";

- "Establish and implement procedures for the ***receipt, retention and treatment of complaints received by the Company***";

- "Discuss with the Company's General Counsel legal matters that may have a material impact on the financial statements or the Company's compliance policies";

- "Discuss with management and the independent auditors ***any correspondence with regulators or governmental agencies*** and any published reports which raise material issues regarding the Company's financial statements or accounting policies"; and

- "Discuss with management the Company's earnings press releases, including the use of 'pro forma' or 'adjusted' non-GAAP information, as well as financial information and earnings guidance provided to analysts and rating agencies."

(Compl. ¶¶ 128-129 [emphases added].) The Audit Committee met nine times during 2007 and a similar number of times in 2008. (*Id.* ¶ 130.) Each member of the Committee has a substantial likelihood of liability for: voting unanimously to enter into the R&H Merger as it was presented to them by Liveris and other officers; failing to insist that the deal contain contingencies protective of Dow; failing to identify the financial risks from the K-Dow and R&H deals, both singly and in combination; failing to detect and prevent insider trading of Dow shares by the Insider Selling Defendants; and failing to detect the material inaccuracy in Dow's financial statements and cause them to be corrected to reflect the risk and discount in value arising from the K-Dow and R&H deal combination. (*Id.* ¶ 131.)

Similarly, as members of the Compensation Committee, Defendants Ringler (Chair), Barton, Hess, and Shaw had the ultimate responsibility at the Company for evaluating the compensation of the Company's executives and employees, as well as to:

- "provide oversight for the compensation philosophy of the Company";
- "assist the Board in reviewing and monitoring processes related to executive succession plans";
- "***review and approve employment agreements, severance, change-in-control, or deferred compensation arrangements, and any special supplemental benefits for the CEO and other Senior Executives***."

(Compl. ¶ 132 [emphases added].) This Committee would have had access to materials and information on the performance of Dow relative to its various business sectors, so that they could evaluate the performance of the CEO and other executive officers in relation to their compensation. (*See id.*) The Compensation Committee met five times during 2007 and a similar number of times in 2008. (*Id*. ¶ 133.) Each member of the Committee has a substantial likelihood of liability for failing to detect, prevent, or alleviate the grossly reckless conduct of Liveris set forth in the Complaint, including by terminating or demoting him, or otherwise constraining his range of activities, and failing to prevent the payment of excessive and wasteful compensation to officers and directors of Dow set forth above at a time when the Company faced grave financial risks from the K-Dow and R&H deal combination. (*Id.* ¶ 134.)

Likewise, as the members of the Company's Governance Committee, Defendants Stern (Chair), Bell, Fettig, and Franklin had the ultimate responsibility at the Company to:

- "[d]evelop qualification criteria for members of the Board of Directors";
- "***[p]rovide oversight of corporate governance matters***"; and
- "[r]ecommend to the Board a code of business conduct and ethics applicable to employees, officers and directors of the Company and the process for consideration and disclosure of any requested waivers of such codes for directors or executive officers of the Company."

(Compl ¶ 135 [emphasis added].) This Committee met five times during 2007. (*Id.*) Each member of the Committee has a substantial likelihood of liability for: allowing Liveris to occupy the offices of CEO, Chairman, COO, and Chairman of the Executive Committee simultaneously; allowing Liveris to dominate and control all other directors and preclude them from exercising independent business judgment; allowing the overlap in membership of the Audit Committee and the Governance Committee; as Governance Committee members, appointed themselves to the Audit Committee; allowing Franklin to serve as Chair of the Audit Committee despite her lack of independence from Liveris; and allowing Liveris to simultaneously sit on the Board of Citigroup, which is a lender to Dow on the key $13 billion bridge facility upon which the R&H deal is dependent. (*Id.*)

F. The Existence of "Red Flags" Establishes that the Director Defendants Consciously Disregarded Their Duties

The Complaint alleges a series of wrongful acts, many of which are interrelated, that evidence an abandonment or abdication of the Board's fiduciary duties, including a lack of loyalty, good faith, and oversight.

The facts alleged in the case at bar are similar to, and require the same outcome as, the *Disney* decision discussed *supra*, part II.A. Although the Board and its Committees undoubtedly were aware of Liveris's and Merszei's claims to shareholders that the R&H Merger in no way depended on K-Dow, the truth was otherwise, as Dow later admitted in its Answer to the R&H lawsuit. Yet the directors took no steps to prevent Liveris or Merszei from doing so. Why didn't they? The reasonable inference is that they had a stake in the deception: they knew that their acts could not withstand public scrutiny. As in *Disney*, the Board is adequately alleged to have consciously failed to fulfill the task over which they had primary responsibility. *See Disney*, 825 A.2d at 280-82.

As discussed *supra*, part II.A, courts excuse demand where a plaintiff demonstrates a lack of good faith by pleading ***either*** conscious inaction by the Board to known problems, ***or*** a sustained or systematic failure to exercise oversight. In the latter case, demand futility is ordinarily found when such a failure involves a scheme of significant magnitude and duration which went undiscovered by the directors as a group. The Delaware Supreme Court has made clear that such a failure of oversight can arise either from a failure to implement any reporting or control system, or, having implemented such a system, from a conscious failure to monitor or oversee its operations, thus disabling directors from being informed of risks or problems requiring their attention. *Stone v. Ritter*, 911 A.2d 362, 367, 370 (Del. 2006). As illustrated by the cases discussed and relied on herein, under any of the above standards, Dow Board members are alleged to face a substantial likelihood of liability, and demand therefore is excused.

In re Countrywide Fin'l Corp. Deriv. Litig., 554 F. Supp. 2d 1044, 1080-82 (C.D. Cal. 2008), is directly on point and informative. There, the court denied a motion to dismiss, for failure to plead demand futility, a complaint alleging that directors of a prominent mortgage loan originator had knowingly allowed the company's underwriting standards to decline. The court specifically analyzed the duties of the Board's various committees, including audit, finance, credit, and public policy, and found that those duties, to have been fulfilled, would necessarily have involved the committee members' awareness of the declining underwriting standards, given the existence of specific "red flags" (such as the a dramatic "rise in negative amortization resulting from pay-option ARMs held for investment" and "increasing delinquencies in Countrywide's riskiest loans") that the directors "must necessarily have examined . . . in the course of their Committee oversight duties." *Id.* at 1060. The court held:

> [The committee members] could not ignore the impact of departures from underwriting standards, especially given the public report issued

> by a collation of banking regulators condemning low-documentation loans and the demise of competing lenders later in the Relevant Period.
>
> . . . [T]he Court finds that the Complaint pleads evidence of a "sustained or systematic failure of the board to exercise oversight," *Caremark,* 698 A.2d at 931, so as to create a substantial likelihood of liability for at least the members of those Committees. It defies reason, given the entirety of the allegations, that these Committee members could be blind to widespread deviations from the underwriting policies and standards . . . . At the same time, it does not appear that the Committees took corrective action. Though the Complaint leaves many details unpled, it provides enough of a factual basis for this Court to determine that a majority of the directors are "interested" for demand purposes at this juncture . . . .

Id. at 1082 (footnotes and citations to pleadings omitted).

Similarly informative is *McCall v. Scott*, in which the Sixth Circuit held that the directors' sustained failure to act against a corporation's systematic health care fraud occurring over two years (less than the three years at issue here) alleged sufficient facts to present a "substantial likelihood of liability." 239 F.3d at 814, 819. Reversing the district court's dismissal of the claims, the appeals court held that particularized facts were alleged to present a substantial likelihood of director liability for intentional or reckless breach of duties through awareness of the fraud, including: (i) "the prior experience of a number of the defendants as director or managers" (a "significant factor" in the Court's assessment); (ii) the existence of a federal investigation; (iii) ongoing practices at the company; (iv) allegations brought against the corporation in civil proceedings; and (v) newspaper reportage. *See id.* at 819-20, 822-23.[10]

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[10] The facts alleged by Plaintiffs are analogous to those found sufficient to excuse demand in *Countrywide* and *McCall v. Scott*. As in those cases, the Complaint alleges the existence of numerous "red flags" that made the Director Defendants well aware of the risk that the R&H Merger would collapse. And as in *McCall v. Scott,* the Director Defendants here have vast prior experience as directors and managers of corporations that enabled them to easily process these "red flags." (*See* Compl. ¶¶ 27-39.)

Recently, the Honorable Colleen McMahon of the Southern District of New York denied a motion to dismiss on demand futility grounds. *See In re Veeco Instruments, Inc. Sec. Litig.*, 434 F. Supp. 2d 267 (S.D.N.Y. 2006). Again like the instant Complaint, the *Veeco* plaintiffs alleged that the company's board had oversight over legal and regulatory matters yet did not discover significant financial fraud:

> The significance of the TurboDisc division—both in terms of the money expended to acquire it and the value it purportedly added [sic] the Company—coupled with the Audit Committee's role in reviewing matters that significantly impact on the Company's financial disclosures, suggest that the Committee was duty-bound to ensure that Veeco implemented an adequate system of internal controls when integrating the TurboDisc division.

Id. at 277. Similarly, the plaintiffs alleged that Veeco's audit committee had abdicated their responsibility when, barely seven months after an internal audit had discovered a $15 million violation of federal export control laws, a second set of violations occurred. *See id.* at 278. In light of these allegations, the court concluded: "This is not a case where the directors had 'no grounds for suspicion' or 'were blamelessly unaware of the conduct leading to the corporate liability,'" and demand therefore was excused as futile. *Id.* (citing *Caremark*, 698 A.2d at 969). So, too, should be the result here.

Other cases suggest the same conclusion. For example, in *Abbott Laboratories*, the Seventh Circuit noted that several of the directors were members of the Board's audit committee, which, similarly to the instant action, was charged with "assessing any risks involved in regulatory compliance." *Abbott Labs.*, 325 F.3d at 808. The Court further noted that the directors "had a fiduciary duty under the SEC to comply with 'comprehensive government regulations' . . . ." *Id.* The Seventh Circuit, stating that continuing violations of federal regulations—including the receipt of warning letters from the Food and Drug Administration

("FDA") and the eventual withdrawal of products and the payment of a $100 million fine to the FDA—"could not be minimized," and used these facts to form the basis for finding "***inferred awareness of the problems***" on the part of the entire Board of Directors. *Id*. at 808-09 (emphasis added).[11]

Furthermore, in *Saito*, the court denied a motion to dismiss because, drawing all reasonable inferences in his favor, the plaintiff had alleged sufficient facts to establish that Board was aware or should have been aware of accounting irregularities at the company—including knowledge that the 1997 audit was "high risk," audit committee discussion of risks, knowledge that certain accounting practices at company were "***a problem***," and advice that "there could be a ***potential*** SEC issue." 2004 Del. Ch. LEXIS at *33 (emphases added). The Delaware Chancery Court's finding of demand futility in *Saito*—which involved only vaguely-defined "problems" and "potential" issues—should lead, a fortiori, to a finding of demand futility here, where the known misconduct is extremely well defined and the issues—including the SEC discipline imposed in 2007—were actualized ones.

In sum, based on the above case law, the Complaint meets either standard—conscious inaction ***or*** a sustained or systematic failure to exercise oversight—necessary to excuse demand

[11] *See also In re Cendant Corp. Deriv. Action Litig.*, 189 F.R.D. 117, 125 (D.N.J. 1999) (demand excused as futile on audit committee members where plaintiff alleged that directors "knew or recklessly disregarded the existence of the accounting irregularities," including numerous "red flags" regarding merger partner's prior accounting machinations); *Oxford Health Plans*, 192 F.R.D. at 115-16 (demand excused as futile where Board was alleged to have continued to support and retain former CEO and Chairman as a consultant despite knowing he was responsible for billing and insurance problems that had drawn regulatory actions by the Governor of New York and the Superintendent of Insurance of New York); *In re American Int'l Group, Inc. Consol. Deriv. Litig.*, C.A. No. 769-VCS, 2009 Del. Ch. LEXIS 15 (Del. Ch. Feb. 10, 2009) (demand excused as futile where facts were pleaded allowing inference that Board had been aware of fraudulent or criminal misconduct).

for Board inaction.

G. The *Citigroup* Decision *Supports* a Finding of Demand Futility Here

Defendants place principal reliance on *In re Citigroup Inc. Shareholder Deriv. Litig.*, 964 A.2d 106 (Del. Ch. 2009). *See* Def. Mem. at 3, 14, 17, 18, 30, 31, 32, 33. Contrary to Defendants' argument, however, *Citigroup* does not negate a finding of demand futility here but, rather, ***supports*** such a finding.

Citigroup was a shareholder derivative action against the directors and officers of Citigroup Inc. to recover massive losses that the company had experienced from investment in subprime mortgage-related securities. *See Citigroup*, 964 A.2d at 111, 112-14. The plaintiffs therein alleged that the defendants had failed to monitor risks, disregarding multiple "red flags" showing the company's huge downside exposure. *See id.* at 111-12, 114-15. The defendants moved to dismiss, and the Delaware Chancery Court applied the *Caremark* test in holding that the plaintiff must show "bad faith" misconduct in order both to demonstrate a "substantial likelihood" of liability sufficient to excuse demand and to avoid the preclusive effect of a corporate charter provision exculpating directors from all but intentional or bad-faith misconduct. *See id.* at 120-23, 125. In analyzing what constituted "bad faith" sufficient to make these showings, the court defined bad faith as the "conscious disregard of responsibilities such as by failing to act in the face of a known duty to act." *Id.* at 123 (citing *Guttman v. Huang*, 823 A.2d 492, 506 (Del. Ch. 2003)).

In applying these principles, the Chancery Court began by noting that the facts of the case were completely unlike the "typical *Caremark* situation." *Citigroup*, 964 A.2d at 123. Whereas *Caremark* addressed the failure to properly monitor or oversee employee ***misconduct*** or ***violations of law***, the plaintiffs "in contrast, base their claims simply on defendants' failure to properly monitor Citigroup's ***business risk***, specifically, its exposure to the subprime mortgage market." *Id.* To underscore this distinction, the court repeated it several more times—in the process distinguishing cases relied upon by Plaintiffs herein. *See id.* at 126, 127, 128, 129 (distinguishing *McCall v. Scott* as having involved alleged "red flags" making Board aware of earlier misconduct of the same type as that at issue in the case), 130 (distinguishing *American Int'l Group* as having involved alleged failure to exercise oversight over known fraudulent or criminal misconduct), 131 ("There are significant differences between failing to oversee employee fraud or criminal conduct and failing to recognize the extent of a company's business risk.").

In contrast, the Chancery Court held, the supposed "red flags" relied upon by the *Citigroup* plaintiffs were not "red flags" at all, but simply involved phenomena like decreased loan originations, losses by other subprime investors, downgrades of subprime-based securities, increasing subprime defaults, and the like. In these circumstances, the court held, the plaintiffs were suing the directors, in essence, simply for exercising their business judgment. *See Citigroup*, 964 A.2d at 124. Thus, the claim was a nothing more than a series of allegations that the Citigroup Board should have micro-managed a vast number of everyday, ordinary business decisions and countermanded management's day-to-day business judgments. *See id.* at 124-25.

The facts in the case at bar are categorically different from those that were present in *Citigroup*, and they dictate the opposite outcome. This case involves a single egregious "bet the Company" transaction in which the Board was intimately involved, both in its inception and in later activities designed to conceal its recklessness. And, unlike in *Citigroup* (and as in the cases distinguished by it), there ***are specific allegations of known misconduct and illegality—i.e., traditional "red flags" establishing Board awareness and conscious participation in the precise***

misconduct. Indeed, the allegations as whole clearly satisfy the "failing to act in the face of a known duty to act" standard enunciation by the Chancery Court in *Citigroup*:

Duty to act—the Director Defendants are alleged to have had a duty to monitor Dow's compliance with regulatory and legal requirements, as well as internal ethical requirements, and to ensure that there were no material misrepresentations to shareholders concerning the relationship of the K-Dow venture to the R&H Merger. To be perfectly clear, Plaintiffs do not maintain that these *post hoc* misrepresentations caused the R&H Merger to be executed, but rather that they provide a strong inference of the Board's knowledge that the deal was wrongful, or too reckless to be exposed to public scrutiny. They show an inconsistency between inking the R&H Merger, and frankly discussing its risks. *See, e.g.*, *Reeves v. Sanderson Plumbing Prods.*, 530 U.S. 120, 133 (2000) (a "cover up" creates a reasonable inference of underlying unlawful conduct, and the factfinder is entitled to consider a party's dishonesty about a material fact as "affirmative evidence of guilt"); *United States v. Rezko*, 2008 U.S. Dist. LEXIS 91576, at *45 (N.D. Ill. Nov. 12, 2008) ("[t]he law is clear that an attempt to cover up or conceal actions is evidence of consciousness of guilt and guilt itself").

Knowledge of duty—Each member of the Dow Board is alleged to have been aware of his or her duties to monitor the Company's exposure to regulatory and legal inquiries, as well as its exposure to excessive financial obligations while lacking binding financing commitments or binding contracts to fund those obligations.

Failure to act—The Complaint alleges a failure to act on the part of the responsible Director Defendants, inasmuch as, despite the fact that, as later admitted by Dow, the R&H Merger, in fact, had been dependent on K-Dow all along, the Board members, in fact, knowingly allowed Liveris and Merszei to represent that the transactions were independent so as to conceal the true risks undertaken by the Board. The Board's acquiescence in this misconduct led to grave consequences for Dow.

III. DOW'S CERTIFICATE OF INCORPORATION DOES NOT SHIELD DEFENDANTS FROM LIABILITY

Defendants mistakenly claim that they are shielded from liability by Dow's certificate of incorporation, adopted pursuant to 8 Del. Code § 102(b)(7), which they claim negates the "substantial likelihood" of liability necessary to excuse demand. Def. Mem. at 20-21. However, Section 102(b)(7) does *not* allow for exculpation for acts or omissions not in good faith, which constitute a breach of the duty of loyalty, or which involve intentional misconduct or knowing violation of law. *Emerald Partners v. Berlin*, 787 A.2d 85, 90 (Del. 2001); *Disney*, 825 A.2d at 286. It compels dismissal only if a complaint states a "residual" breach of the duty of care—*and nothing else*. *Malpiede v. Townson*, 780 A.2d 1075, 1094 (Del. 2001); *Emerald Partners*, 787 A.2d at 91. The misconduct at issue here—agreeing to the R&H Merger in bad faith and conscious failure of oversight with respect to Dow's dealings with foreign governments and its statements to shareholders—indisputably implicates the duties of loyalty and good faith—i.e., nonexculpated claims. *See McCall*, 239 F.3d at 1001; *Disney*, 825 A.2d at 290. Moreover, Section 102(b)(7) is in the nature of an affirmative defense, not properly before this Court on a motion to dismiss. *See Emerald Partners*, 726 A.2d at 1223; *Abbott Labs.*, 325 F.3d at 810 (applying Illinois counterpart to § 102(b)(7)); *Sanders v. Wang*, No. 16640, 1999 Del. Ch. LEXIS 203, at *34-*35 (Del. Ch. Nov. 8, 1999); *In re Ply Gem Indus. S'holders Litig.*, No. 15779, 2001 Del. Ch. LEXIS 84, at *40 (Del. Ch. June 26, 2001).

IV. THE MOTION TO DISMISS TO THE EXTENT IT IS PREMISED UPON FAILURE TO STATE A CLAIM

Defendants argue that the claim for contribution (Count III) should be dismissed for failure to state a claim. This argument is premature, and the motion should be denied to the extent that it is based on this ground. *See Daystar Construction Mgmt., Inc. v. Mitchell*, C.A. No. 04C-05-175-JRS, 2006 Del. Super. LEXIS 286, at *41-*42 (Del. Super. July 12, 2006) (declining to dismiss contribution claims).

V. PLAINTIFFS SHOULD BE GIVEN LEAVE TO REPLEAD

Plaintiffs are confident that the Complaint is more than sufficient under the applicable pleading standards to excuse demand and state a claim. However, should the Court grant any part of Defendants' motion to dismiss or require more specific pleadings, Plaintiffs respectfully request that this Court permit amendment, consistent with Chancery Court Rule 15(aaa) (dismissal under Rule 12(b)(6), 12(c) or 23.1 may be without prejudice and with leave to amend if "the Court for good cause shown shall find that dismissal with prejudice would not be just under all the circumstances"). *See Good v. Getty Oil Co.*, 514 A.2d 1104, 1109 (Del. Ch. 1986) (granting leave to amend derivative claims following dismissal for failure to plead demand futility).

CONCLUSION

For the foregoing reasons, Defendants' Motion to Dismiss should be denied in its entirety.

Dated: July 20, 2009

Respectfully submitted,

ROSENTHAL, MONHAIT & GODDESS, P.A.

By: */s/ Carmella P. Keener*

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